

DOCKET SECTION

**OFFICIAL TRANSCRIPT OF PROCEEDINGS
BEFORE THE
POSTAL RATE COMMISSION**

In the Matter of:)

POSTAL RATE AND FEE CHANGES)

Docket No.: R2006-1

VOLUME #32

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POSTAL RATE COMMISSION

In the Matter of:)
) Docket No.: **R2006-1**
 POSTAL RATE AND FEE CHANGES)

Suite **200**
 Postal Rate Commission
901 New York Avenue, N.W.
 Washington, D.C.

Volume **32**
 Wednesday, November **29**, 2006

The above-entitled matter came on for hearing
 pursuant to notice, at **9:35** a.m.

BEFORE:

HON. GEORGE A. **OMAS**, CHAIRMAN
 HON. DAWN A. TISDALE, VICE-CHAIRMAN
 HON. RUTH Y. GOLDWAY, COMMISSIONER
 HON. TONY HAMMOND, COMMISSIONER
 HON. MARK ACTON, COMMISSIONER

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WITNESSES APPEARING:

W. ASHLEY LYONS
 MAURA ROBINSON
 J. GREGORY SIDAK
 ROGER C. PRESCOTT

<u>WITNESSES:</u>	<u>DIRECT</u>	<u>CROSS</u>	<u>REDIRECT</u>	<u>RECROSS</u>	<u>VOIR DIRE</u>
W. Ashley Lyons	10679	--	--	--	--
Maura Robinson	10695	--	--	--	--
By Mr. Horwood	--	10725	--	--	--
	--	10733	--	--	--
By Mr. Scanlon	--	10737	--	--	--
By Mr. McKeever	--	10767	--	--	--
	--	10806	--	--	--
By Mr. Olson	--	10814	--	--	--
J. Gregory Sidak	10817	--	--	--	--
By Mr. McLaughlin	--	10847	--	--	--
By Mr. Koetting	--	10872	--	--	--
	--	10891	--	--	--
By Mr. Olson	--	10913	--	--	--
By Mr. Todd	--	10923	--	--	--
Roger C. Prescott	10931	--	--	--	--
By Mr. Olson	--	10959	--	--	--

C O N T E N T SDOCUMENTS TRANSCRIBED INTO THE RECORDPAGE

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E X H I B I T S

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P R O C E E D I N G S

(9:35 a.m.)

CHAIRMAN OMAS: Good morning. Today we begin our final set of hearings in Docket No. R2006-1. We will hear testimony in rebuttal to participants' direct testimony.

Four witnesses are scheduled to appear today: Ashley Lyons, Maura Robinson, Gregory Sidak and Roger Prescott.

Before we begin, does anyone have any procedural matter to discuss at this point?

(No response.)

CHAIRMAN OMAS: Hearing none, Mr. Lyons, would you please stand? Raise your right hand.

Whereupon,

W. ASHLEY LYONS

having been duly sworn, was called as a witness and was examined and testified as follows:

CHAIRMAN OMAS: Please be seated.

Counsel?

MR. REITER: Good morning, Mr. Chairman, Commissioners.

(The document referred to was marked for identification as Exhibit No. USPS-RT-3.)

1 DIRECT EXAMINATION

2 BY MR. REITER:

3 Q Mr. Lyons, you have before you two copies of
4 a document entitled Rebuttal Testimony of W. Ashley
5 Lyons on behalf of United States Postal Service, No.
6 USPS-RT-3.

7 Was that testimony prepared by you or under
8 your direction?

9 A Yes, it was,

10 Q And if you were to testify here orally today
11 would that be the same testimony you would give?

12 A Yes, it would be.

13 MR. REITER: Mr. Chairman, I will present
14 the copies to the reporter and ask that they be
15 entered into evidence as the rebuttal testimony of
16 Ashley Lyons.

17 CHAIRMAN OMAS: Is there objection?

18 (No response.)

19 CHAIRMAN OMAS: Hearing none, I will direct
20 counsel to provide the reporter with two copies of the
21 corrected rebuttal testimony of Witness Lyons.

22 That testimony is received into evidence and
23 is to be transcribed into the record.

24 //

25 //

1 (The document referred to,
2 previously identified as
3 Exhibit No. USPS-RT-3, was
4 received in evidence.)

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USPS-RT-3

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2006 :

Docket No. R2006-1

REBUTTAL TESTIMONY OF
W. ASHLEY LYONS
ON BEHALF OF
UNITED STATES POSTAL SERVICE

AUTOBIOGRAPHICAL SKETCH

1
2
3
4 My name is Ashley Lyons. I am the manager of Corporate Financial
5 Planning for the United States Postal Service. As manager of Corporate
6 Financial Planning, I am a direct report to the Chief Financial Officer
7 responsible for a variety of financial analyses, planning and forecasting
8 matters, revenue and volume reporting, cost attribution and other costing
9 matters. Prior to this assignment which began in June of this year, I was the
10 manager of Pricing, a position I had held since 1996. In that position I was
11 responsible for the development of Postal Service pricing proposals for
12 domestic mail classifications and international postal pricing.

13
14 I began my career with the Postal Service in August, 1974, working in the
15 Bulk Mail Processing Department. Subsequently, transferred to the
16 Washington Bulk Mail Center's Control and Logistics Department, I later
17 became Safety Manager at the facility. I then returned to the Postal
18 Service's headquarters where I worked in the areas of mail classification
19 and cost analysis. My primary responsibilities in these two functions were to
20 develop regulations and aid in the Postal Service's costing efforts in Docket
21 No. R80-1.

22
23 I then served in the Office of Rates. My primary duties were the
24 development of the Postal Service rate level proposals for all domestic mail
25 classifications and the design of First-class Mail and Priority Mail rates.
26 Other major areas of responsibility were the analysis of postal revenue
27 forgone appropriation and other issues related to preferred postal rates.

28
29 In 1993, I became the manager of Workload and Productivity Analysis in the
30 budget function. Along with workload and productivity functions, I was
31 responsible for coordinating the development of budgets presented to the

1 Congress and the Office of Budget and Management along with the revenue
2 requirement in Docket No. R94-1.

3

4 In previous positions, I testified before the Postal Rate Commission twice in
5 Docket No. R84-1, in Docket No. R87-1, twice in Docket No. 90-1, and twice
6 in Docket No. MC96-3. This marks my first appearance as a witness at the
7 Postal Rate Commission in almost a decade.

8

9 I received a Bachelor of Science degree in 1974 from the University of
10 Alabama where I majored in transportation and public utilities. In 1984, I
11 received a Master of Business Administration degree from George
12 Washington University.

1 I. PURPOSE AND SCOPE OF TESTIMONY

2
3 My testimony rebuts Direct Marketing Association's witness Buc's (DMA-
4 T-1) proposal to reduce the Postal Service's revenue requirement for the Test
5 Year. I will demonstrate that his testimony does not support changing the
6 revenue requirement.

7
8 II. AN APPROPRIATE LEVEL OF SUPERVISORY COST REDUCTIONS HAVE
9 ALREADY BEEN INCLUDED IN THE REVENUE REQUIREMENT.

10
11 Witness Buc asserts that the Postal Service has overstated the revenue
12 requirement by understating the cost reduction programs for supervisors. He
13 posits that the supervisory costs vary in direct proportion to the craft labor
14 supervised, and therefore, the cost reduction projection should be increased to
15 include additional supervisory reductions related to specific cost reduction
16 programs identified in LR-49.

17 Witness Buc fails to demonstrate that supervisory costs, either in general
18 or specifically relative to cost reduction program implementation, are reduced in
19 direct proportion to craft labor costs; in fact, he admits that over certain time
20 periods supervisory costs do not decline in direct proportion to craft labor costs.¹
21 No evidence has been presented that cost reduction programs generate
22 supervisory savings proportional to craft savings. Witness Buc also fails to
23 recognize the Postal Service's approach to identifying and capturing supervisory
24 cost reductions as outlined in witness Loutsch's testimony:²

25 Between specific cost reduction programs and BPI, the Postal Service
26 identifies realizable cost savings for technical personnel and supervisors.
27 Cost reduction program implementations and supervision of operations
28 frequently require additional supervisory time and attention in order to
29 capture cost savings, to maintain service, and to ensure operating
30 efficiencies. Therefore, the Postal Service specifically examines a
31 program's cost savings opportunities, including those relating to Cost
32 Segment 2, rather than making assumptions that supervisor costs follow in

¹ Tr. 22/8044.

² USPS-T-6, page 31, lines 5-20.

lockstep with estimated changes in craft staffing levels. Most cost reduction programs result in changes to the work environment. While a supervisor may have less people to supervise in the new environment, other responsibilities related to the new equipment and/or a changed environment add to a supervisor's workload. There are also ongoing responsibilities that do not change as a result of fewer employees, e.g., budget, safety, operating performance data monitoring, and coordination of mail flows. While not directly related to specific programs, supervisory, technical, and administrative savings are being pursued via the BPI/LMI processes.

The effect of witness Buc's proposal would increase cost reductions beyond the level that is predicted to occur by the Postal Service in the rate filing and the FY 2007 Operating Budget. Such a reduction would also reduce the revenue requirement for funds already spent in FY 2006. Witness Oronzio (USPS-RT-15) describes the approach used by the Postal Service to identify, plan and capture potential supervisory cost reductions. The approach he describes means that reductions in supervisory costs are already reflected in the program estimates or in the estimates of Breakthrough Productivity Initiatives and Local Management Initiatives (BPI/LMI). To make further reductions, as witness Buc proposes, would be unjustified and would result in an overstatement of expected savings.

III. THE REVENUE SURPLUS, AS ADJUSTED, IS REASONABLE AND CONSISTENT WITH THE REORGANIZATION ACT REQUIREMENTS.

Witness Buc states that the proposed rates lead to a revenue surplus that is excessive. The Reorganization Act requires that: "Postal rates and fees shall provide sufficient revenue so that total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service." 39 U.S.C. ¶ 3621.

What constitutes "equal as nearly as practicable" is judgmental. The original revenue requirement had a revenue surplus of \$0.8 million. As a result of errata, the surplus increased to \$173 million, but was subsequently reduced to \$97

1 million after the changes and reconciliation of revenue provided in response to
2 POIR 16. This corrected estimate of surplus in the test year of \$97 million
3 represents just over 0.1 percent of the total revenue requirement. My belief is
4 that 0.1 percent represents a reasonable and good faith attempt to balance
5 revenues and costs as “nearly as practicable.” During his cross examination,
6 Witness Buc agreed.³

7
8
9 IV. ACTUAL 2006 NET INCOME IS FULLY CONSISTENT WITH THE
10 REVENUE REQUIREMENT TESTIMONY

11
12 Witness Buc uses interim financial data in an attempt to anticipate 2006
13 results, and, based on this analysis, argues that the revenue requirement
14 estimate is “unlikely.”⁴ Based on actual 2006 audited financial results approved
15 by the Board of Governors, the Postal Service’s incurred a net **loss** of \$2.058
16 billion, after consideration of the **escrow**.⁵ These overall results are consistent
17 with the estimated FY 2006 revenue requirement **loss** of \$2.075 billion⁶

18 The financial statements show that while actual revenue was \$649 million
19 higher than the rate case estimate, expenses were also higher by \$632 million.
20 The primary expense variances are described in the following paragraphs.

21 Labor costs were \$254 million higher than estimated overall, due to increased
22 workyear usage of \$602 million, offset by lower-than-expected average labor
23 costs of \$349 million. The labor usage increase results from higher-than-
24 expected volume, but it also indicates that the planned cost reductions were not
25 fully achieved. After seven years of significant productivity gains, continued cost
26 reduction can be expected to become more challenging, nevertheless
27 management remains committed to continue the substantial productivity
28 improvement outlined in the revenue requirement.

³ Tr. 22/8047. (“if you were at .1 that I would say that’s as nearly as practicable.”)

⁴ DMA-T-1, page 10, line 13.

⁵ See Library Reference USPS-LR-195 (FY 2006 Financial Statements and Management Discussion and Analysis).

⁶ Postal Service response to POIR 16.

1 The workers' compensation ~~costs~~ increased \$441 million to \$1,279 million in
2 2006 from \$838 million in 2005. Even though the revenue requirement estimate
3 included a substantial increase in workers' compensation expense over the base
4 year level, the revenue requirement estimate was \$163 million less than the
5 actual 2006 expense. I have been informed by our Accounting management that
6 increases over the amounts included in the revenue requirement may result in
7 2007 and 2008, as we convert to a new modeling approach.

8 Finally, transportation costs in 2006 increased by 11.2 percent, or \$608
9 million, when compared to 2005. A portion of this increase, 6.4 percent, was
10 anticipated in the revenue requirement estimate, but the 2006 revenue
11 requirement estimate was approximately \$260 million less than the actual results.
12 Approximately half of the 2005-2006 change was due to increased fuel costs,
13 with the remainder due to increased usage as a result of increased mail volume
14 and increased contract costs. While fuel prices have recently moderated, the
15 revenue requirement estimate assumes that a combination of moderate inflation,
16 declining volume workload, and significant cost reduction programs will result in
17 declining transportation costs in after rates 2007 and 2008 of 3.0 to 3.8 Percent
18 per year.'

19 On September 18, 2006, the Postal Service submitted the FY 2007 Integrated
20 Financial Plan (IFP) to the Commission. Witness Buc dismisses this plan as "not
21 tested and not gone through the same way that a rate case estimate is."⁸ But the
22 fact remains that the 2007 Integrated Financial Plan is the Board of Governors
23 approved Postal Service's budget that establishes the expectations and goals for
24 the coming year. Even without an attempt to update the revenue requirement
25 estimates, a comparison of the 2007 after rates revenue requirement estimate to
26 the 2007 IFP provides insight concerning changes in estimates that have
27 occurred since the finalization of the revenue requirement estimates.

⁷ **USPS-T-6**, Tables 44 and 45, pages 49-50.

⁸ Tr. Vol. 22/8048-8049.

1 The 2007 IFP projects a worsening of Postal Service finances when
2 compared to the revenue requirement estimates. The IFP budgets a Net
3 Deficiency After Escrow⁹ of \$1.576 billion versus the revenue requirement 2007
4 After Rates deficiency of \$1.151 billion, a \$425 million decline. The 2007 IFP
5 budgets an increase in revenues of \$744 million (\$75.273 billion – \$74.529
6 billion) on a volume increase of 853 million pieces, when compared to the
7 revenue requirement estimate. The 2007 IFP revenue forecast is based on
8 revenue and volume results through June 30, 2006, and incorporates the
9 revenue increases that occurred during that period. While the increased revenue
10 is a positive development, the IFP continues to project an overall volume decline
11 of approximately 1.2 billion pieces, including a decline in First-class Mail volume
12 of 2.8 billion pieces, offset by an increase in Standard Mail of 2.0 billion pieces.

13 Offsetting the better-than-expected revenue is a substantial expense
14 increase. The IFP includes an expense budget of \$76.849 billion (\$73.564 total
15 expenses plus \$3.285 billion escrow). This budget is \$1.169 billion over the
16 estimates included in the revenue requirement. The increase is primarily driven
17 by increased personnel costs, resulting from additional workload and the
18 September COLA, and increased transportation costs.

19 Labor costs were significantly increased by the September 2006 COLA.
20 As mentioned in the Postal Service response to POIR 13, actual COLAs
21 exceeded those included in the revenue requirement estimate. The difference
22 between the estimates is over \$500 per bargaining unit employee, and will
23 increase 2007 revenue requirement estimate by more than \$400 million. This
24 increase will carry forward into the Test Year resulting in at least a **\$400** million
25 increase in expense.

26 In POIR 16, the Commission inquired concerning the impact of the OPM
27 announcement that health benefits premiums would increase by only 1.8 percent
28 in FY 2007. We noted that Postal Service premiums, assuming no open season
29 plan changes, would increase 2.3 percent. Published reports indicated that the

⁹ Integrated Financial Plan FY 2007, Executive Summary, page 1.

1 premium increases were being reduced 5 percent through the application of
2 OPM health benefit fund reserves. The Postal Service premiums apparently
3 would have increased by more than the 7 percent estimate in the revenue
4 requirement, if reserve funds had not been applied. We reviewed the history of
5 OPM health benefits premium changes, and in FY 1986 and 1987 a similar
6 application of reserves took place. The announced reduction in the premiums
7 was 0.5 percent in 1986, followed by a 12 percent reduction in 1987. In 1988,
8 however, premium rates increased 17 percent, and in 1989 premium increases
9 were over 25 percent. Therefore, based on the reversal of the premium
10 reductions in years subsequent to the buy-down with reserves, I believe any
11 adjustment to estimated health care costs for the Test Year is premature,
12 inappropriate and risky, especially with only a 1 percent contingency.

13 Transportation costs are expected to increase from the 2006 actual
14 expense, which already exceeded the 2006 revenue requirement estimate by
15 \$260 million. The total increase in transportation costs in the IFP exceeds the
16 2007 After Rates revenue requirement estimate by over \$650 million. This is
17 driven by high fuel costs, increased volume on FedEx, and scheduled contract
18 increases.

19 With the exception of the health benefits premium buy-down in 2007,
20 expense variances experienced in 2006 and those estimated for 2007 generally
21 will flow through to the test year as base expense level changes, thereby
22 increasing costs in the test year. In summary, witness Buc's criticisms of the
23 projected cost estimates underlying the revenue requirement are **not** supported.
24 Rather, the record and recent events demonstrate that the Postal Service's 2006
25 revenue requirement estimate was appropriate, but indicates that 2007 may be
26 understated.

27

28 V. THE CONTINGENCY **OF 1 PERCENT** IS REASONABLE UNDER THE
29 CURRENT CIRCUMSTANCES.
30

31 Witness Buc urges the Postal Rate Commission to override
32 management's discretion and reduce the Postal Service's proposed 1 percent

1 contingency to zero.¹⁰ He bases this proposal on three arguments. First,
2 witness Buc argues that, with the Postal Service's equity position at the end of
3 the Test Year, "the Postal Service is far better able to absorb the impacts of an
4 adverse financial occurrence than in the past." Second, witness Buc argues
5 that the Postal Service's strong cash position at the end of the test year allows
6 the Postal Service "to cope easily with an adverse outcome." Finally, witness
7 Buc argues that the Postal Service's financial condition is even better than what
8 appears on the books because real estate is carried at book value rather than
9 market value,¹³ and that the Postal Service will realize substantial gains on the
10 sales of excess facilities resulting from the END program.¹⁴ Witness Buc's
11 arguments ignore the purpose of the provision for contingencies and are based
12 on inaccurate analysis.

13 The selection of an appropriate provision for contingencies has always
14 been an integral part of a responsibly-developed revenue requirement.
15 Congress expected that the Postal Service would include a contingency amount
16 in estimating its future revenue needs. Section 3621 of the Postal
17 Reorganization Act (39 U.S.C. § 3621) provides that:

18 Postal rates and fees shall provide sufficient revenue so that total
19 estimated income and appropriations to the Postal Service will
20 equal as nearly as practicable total estimated costs of the Postal
21 Service. For the purposes of this section, "total estimated costs"
22 shall include (without limitation)...a reasonable provision for
23 contingencies.
24

25 The contingency provision is designed to maintain stability in achieving the
26 break-even mandate, in light of the largely unpredictable consequences of an
27 interplay among a complicated array of economic, social, and political forces, as
28 well as accidents and natural disasters. Therefore, the ultimate decision to
29 include a provision for contingencies is logically and necessarily judgmental, and

¹⁰ DMA-T-1, page 11, line 13.

¹¹ DMA-T-1, page 14, lines 5-6.

¹² DMA-T-1, page 15, lines 1-3.

¹³ DMA-T-1, page 15, lines 9-13.

¹⁴ DMA-T-1 page 16-17.

1 represents a major policy choice by the Board of Governors as to the level of risk
2 with regard to unknown developments that the Postal Service is willing to bear in
3 the test year. The Postal Service has rationally reckoned its proposed provision
4 for contingencies pursuant to this judgmental assessment of the need for a
5 cushion against unknown developments in the test year. This assessment
6 appropriately takes account of a variety of factors, including the Postal Service's
7 expected financial condition, historical experience, the potential for unknown
8 future adversities, and the Postal Service's financial, operational, and ratemaking
9 policies.¹⁵

10 Historically, the Postal Service has proposed contingencies in traditional
11 rate filings that have varied from 1 percent to 4 percent. In Docket No. R2005-1,
12 a specialized case targeted only to provide revenue to cover the Escrow
13 Expense, the Postal Service proposed a 0 percent contingency. But in all other
14 omnibus rate filings, proposed contingencies have fallen within or below the
15 Kappel Commission's suggested range of 3.0 to 5.0 percent. **Also**, over the
16 course of 30 years of postal ratemaking, the Postal Rate Commission has
17 recommended all but two of the Postal Service's contingency requests, which
18 have ranged between 1.0 and 5.0 percent.¹⁶

19 Witness Buc's argument that given the level of equity the Postal Service is
20 far better able to absorb the impacts of an adverse financial occurrence than in
21 the past ignores the purpose of the provision for contingencies described above.

¹⁵ See Rebuttal Testimony of Richard J. Strasser, R2000-1, USPS-RT-1, pages 2-4.

¹⁶ Dockets No. R80-1 and R2000-1 were the only instances in which the Commission recommended reducing the contingency provision. In Docket No. R80-1 an appellate court overruled, as an "unlawful intrusion into the policy-making domain of the Board," the Commission's recommendation that the Postal Service's 3.0 percent contingency provision in that docket be reduced to 1.8 percent. In Docket No. R2000-1, the Governors rejected the Commission's analysis and modified the rates, in part, to provide a sufficient provision for contingencies. Decision of the Governors of the United States Postal Service on the Recommended Decision on Further Reconsideration of the Postal Rate Commission on Postal Rate and Fee Changes (May 7, 2001).

1 Second, the Test Year after rates total equity is \$2.247 billion,” or \$787 less than
2 the U.S. Government’s capital contributions of \$3.034 billion. This means that, at
3 the end of the Test Year, retained earnings will be negative by \$787 million.
4 Implicitly, witness Buc is arguing that, in the case of an adverse event, the Postal
5 Service should and could merely offset the loss with the capital contributions of
6 the U.S. Government. This is inconsistent with the Reorganization Act’s concept
7 of breakeven.

8 Witness Buc also argues that the Postal Service will be able to easily cope
9 with adverse outcomes because at the end of the Test Year the Postal Service
10 will have a cash balance of \$5.587 billion.¹⁸ Witness Buc based this opinion on
11 an inaccurate reading of witness Loutsch’s Exhibit 6-G. Exhibit 6-G, titled
12 “Investment Income” provides the documentation of the expected interest
13 income. The schedule uses average cash balances for the year, not year end
14 balances. The appropriate schedule that identifies cash on hand at year end is
15 the Summary of Cash Flows, LR-50, page 271. This estimate of year end cash
16 balances indicates that at the end of 2008 After Rates the Postal Service expects
17 to have an unrestricted cash balance of \$1.0 billion. I would also point out that
18 the \$1.0 billion cash level represents substantially less than a single two week
19 payroll disbursement. In order to have the \$1.0 billion ending cash balance in
20 2008 After Rates, the Postal Service will be required to borrow \$3.563 billion over
21 the 2006-2008 period to finance capital acquisitions and escrow contributions.
22 The actual estimated cash balance at the end of the Test Year After Rates is
23 designed to ensure that the payroll can be met and provides absolutely no
24 cushion against adverse events.

25 Witness Buc contends that the appraised value of postal real estate is
26 higher than its book value, suggesting that negative equity is overstated. He
27 states that the Postal Service’s financial position is even better than stated in the

¹⁷ See Postal Service response to POIR 16.

¹⁸ DMA-T-1, page 15, line 3.

1 financial statements because real estate is carried at its book value.¹⁹ In other
2 words, he advises us, in effect, not to worry about future deficits resulting from
3 unforeseen events, because the Postal Service is in better financial shape than
4 the books of account would suggest. He also suggests disposing of real estate
5 as an additional source of revenue.

6 This argument ignores the legal and practical realities of postal operations.
7 The Postal Service has universal service obligation and owns real estate for the
8 purpose of supporting and operating a nationwide service network for the long
9 term to satisfy that obligation. In other words, the Postal Service cannot dispose
10 of its real estate at will in order to realize its market value without ignoring the
11 needs of current and future customers.

12 Witness Buc also argues that it is likely that real estate sales and profit in
13 the Test Year will likely be higher as a result of the END program. This is
14 extremely speculative. Based on my understanding of the END program, the
15 initial conversions will not begin until at the earliest sometime in 2008. It is very
16 unlikely that, given the time required to sell a major building, that any material
17 real estate gains in excess of those already included in the miscellaneous
18 revenue estimate will be realized in the Test Year.

19 The Postal Service's contingency provision falls at the lower end of a well-
20 established range of reasonableness and even lower than the range suggested
21 by the Kappel Commission. It is my opinion, as manager of Postal Service
22 Corporate Financial Planning, and based on my years of experience, that witness
23 Buc's proposal to reduce the contingency provision is incompatible with
24 reasonable prudent management.

¹⁹ DMA-T-1, page 15, lines 9-10.

1 CHAIRMAN OMAS: This brings us to oral
2 cross-examination.

3 Is there anyone who wishes to cross-examine
4 Witness Lyons?

5 (No response.)

6 CHAIRMAN OMAS: There being none, Mr. Lyons,
7 you got off lightly today. That concludes your
8 testimony here today. We appreciate your contribution
9 to the record, and you are now excused.

10 THE WITNESS: Thank you.

11 (Witness excused.)

12 CHAIRMAN OMAS: Mr. Tidwell, would you
13 introduce your witness, please?

14 MR. TIDWELL: Good morning, Mr. Chairman,
15 Commissioners. The Postal Service calls Maura
16 Robinson to the stand.

17 CHAIRMAN OMAS: Ms. Robinson, would you
18 please stand?

19 Whereupon,

20 MAURA ROBINSON

21 having been duly sworn, was called as a
22 witness and was examined and testified as follows:

23 CHAIRMAN OMAS: Please be seated.

24 //

25 //

1 (The document referred to was
2 marked for identification as
3 Exhibit No. USPS-RT-10.)

4 DIRECT EXAMINATION

5 BY MR. TIDWELL:

6 Q Ms. Robinson, on the table before you are
7 two copies of a document entitled Rebuttal Testimony
8 of Maura Robinson on behalf of the United States
9 Postal Service. It has been designated for purposes
10 of this proceeding as USPS-RT-10.

11 Was that document prepared by you?

12 A Yes.

13 Q If you were to provide the content of that
14 document as your oral testimony would it be the same?

15 A Yes, it would.

16 MR. TIDWELL: Mr. Chairman, the Postal
17 Service moves into evidence the rebuttal testimony of
18 Maura Robinson.

19 CHAIRMAN OMAS: Is there any objection?

20 (No response.)

21 CHAIRMAN OMAS: Hearing none, I will direct
22 counsel to provide the reporter with two copies of the
23 corrected rebuttal testimony of Maura Robinson.

24 That testimony is received into evidence and
25 is to be transcribed into the record.

1 (The document referred to,
2 previously identified as
3 Exhibit No. USPS-RT-10, was
4 received in evidence.)

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USPS-RT-10

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

REBUTTAL TESTIMONY
OF
MAURA ROBINSON
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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1 AUTOBIOGRAPHICAL SKETCH

2 My name is Maura Robinson. I am the Manager, Pricing Systems and
3 Analysis in Pricing and Classification. My office provides technical pricing and
4 business management support, enabling the development of pricing and product
5 initiatives. Earlier this year, I served as Manager, Transformation in the Strategic
6 Planning Department with responsibility for the development of strategic
7 marketing and finance transformation initiatives. I have been employed by the
8 United States Postal Service since 1998. Through January 2006, I served as an
9 Economist in Pricing and Classification. During that time, I worked on issues
10 relating to Priority Mail, First-class Mail, rate policy, and legislative reform.

11 I have previously testified before the Postal Rate Commission in three
12 dockets. In Docket No. R2005-1, I testified in support of the Postal Service's
13 policy decision to request an "across-the-board" increase in rates and fees to
14 fund the escrow requirement established by the Postal Civil Service Retirement
15 System Funding Reform Act of 2003 (P. L. **108-18**). In Docket No. R2001-1, I
16 presented testimony on First-class Mail rate design, and in Docket No. R2000-1,
17 I testified on the Postal Service's Priority Mail rate proposal.

18 Prior to joining the Postal Service, I worked for the Baltimore Gas and
19 Electric Company from 1992 through 1998. I graduated from the University of
20 Maryland at College Park with a Master's of Arts degree in Economics. I also
21 hold a Bachelor of Science degree in Economics and a Bachelor of Arts degree
22 in French from Iowa State University.

1 I. PURPOSE AND SCOPE OF TESTIMONY

2 Witnesses for several intervenors' have proposed prices or pricing
3 approaches different from those proposed in the Postal Service's direct case.
4 These intervenor proposals have at least one element in common: they arise
5 from, or result in, a flawed assessment of what would constitute acceptable
6 allocation of institutional costs among classes of mail, in accordance with
7 applicable statutory ratemaking criteria. The alternative First-class Mail letter
8 price proposals would also have significant revenue consequences that would
9 cause a distortion of rate policy decisions spreading beyond First-class Mail.

10 My testimony responds to these alternative proposals and explains why
11 the allocation of institutional costs proposed by Postal Service witness O'Hara
12 (USPS-T-31) in this case is most faithful to the pricing criteria of the Postal
13 Reorganization Act and why it should be recommended by the Commission.

14 Various intervenor witnesses in this docket have suggested modifications
15 to the Postal Service's proposal based on their application of specific pricing
16 principles such as Efficient Component Pricing (ECP). However, no intervenor
17 has appropriately balanced the economic efficiency goal which underlies ECP
18 with a full consideration of the context in which postal rates are established. As
19 a result, these proposals typically meet one narrow policy objective rather than

¹ American Postal Workers Union, AFL-CIO witness Kobe (APWU-T-1), Newspaper Association of American witness Sidak (NAA-T-1), Pitney Bowes witness Panzar (PB-T-1), and ValPak witness Mitchell (VP-T-1).

- address the full spectrum of issues that the Postal Service balances in its
- 2 proposal and that the Commission must consider in its recommended decision.

1 II. POSTAL PRICING IS NOT THE MECHANISTIC APPLICATION OF
2 THEORETICAL PRICING RULES

3 Considerable discussion in this docket has surrounded the mechanics of
4 rate design and how "efficient" discounts should be set. In general, the
5 testimonies of American Postal Workers Union, AFL-CIO witness Kobe (APWU-
6 T-1), Newspaper Association of America witness Sidak (NAA-T-1), Pitney Bowes
7 witness Panzar (PB-T-1), and ValPak witness Mitchell (VP-T-1) imply that, if the
8 theory of Efficient Component Pricing is not strictly adhered to, then the resulting
9 prices will not be economically efficient, and therefore, in some sense, they
10 would be inappropriate for the Commission to recommend. I disagree.

11 In developing its pricing proposals, the Postal Service has been guided by
12 the Commission's prior interpretations of the Postal Reorganization Act which
13 recognize the variety of factors that must be appropriately considered and
14 balanced to arrive at a reasonable, comprehensive pricing structure. In its
15 discussion of the Act, the Commission has noted:

16 The language of the Act is quite broad. The objectives of the Act suggest,
17 in one form or another, virtually every standard for equity and efficiency
18 found in economic theory. Many of the objectives of the Act can conflict;
19 thus, the Act assigns to the Commission the judgments that are needed to
20 apply them. It is the Commission's understanding that it has an obligation
21 to evaluate evidence and to recommend rates in consideration of *all* the
22 objectives of the Act. The Commission does not ignore any of them, nor
23 does it adopt rules for attributing and assigning costs that constructively
24 waive any of them.

25 PRC Op. R97-1 at **228** [emphasis in original].

26 This guidance illustrates the delicate balance that the Commission must
27 strike between numerous, often conflicting goals. This balance must weigh not
28 only the merits of each proposal, but must also address the implicit goals of

1 various pricing theories to determine which aspects of each option should be
2 included in the recommended pricing structure.

3 Clearly, encouraging economic efficiency has been an important goal of
4 the Commission's pricing recommendations in prior dockets and has informed
5 the Commission's decisions. However, the Commission has recognized that
6 "[e]conomic efficiency is neither the exclusive nor even the paramount
7 ratemaking objective under the Act." PRC Op. R2000-1 at 210. Consequently,
8 any pricing proposal which suggests that the Commission should adopt an
9 economic theory whose sole purpose is to drive economic efficiency not only
10 overlooks the nine statutory pricing criteria, but also seeks to eliminate the
11 discretion to address the requirements of a given circumstance inherent in the
12 Commission's statutory pricing obligations.

13 A careful reading of intervenors' testimonies suggests that they recognize
14 the tension between economic efficiency and other statutory goals. For
15 example, APWU witness Kobe asserts:

16 For an agency that must weigh efficiency against its public policy
17 responsibilities to the American public at large, I recognize that [providing
18 the correct economic signals] may not be the only criterion for a decision.

19 Tr. 20/7131; response to NAPM/APWU-T1-1. Similarly, Pitney Bowes witness
20 Panzar agreed that:

21 there may be demand side reasons or reasons in accordance with the
22 Postal Statute for deviating from that efficient discount policy.

23 Tr. 26/9155; response to USPS/PB-T1-2, referencing Docket No. R97-1, Tr.
24 34/18465-66. However, these distinctions are often lost in the rhetoric

1 surrounding the value of economically efficient rates and are absent from the
2 proposals that intervenor witnesses have put forth.

3 To evaluate the arguments underlying the merits of economically efficient
4 rates or discounts, it may be useful to begin by considering the role of the
5 statutory postal pricing criteria in establishing rates and fees. These section
6 3622(b) pricing criteria are applied at the subclass level to evaluate and establish
7 the appropriate markups over institutional costs as discussed in the testimony of
a Postal Service witness O'Hara (USPS-T-31). However, once markups are
9 established, the factors enumerated in the pricing criteria do not cease to be
10 relevant in rate design. **At** every step, the Commission must consider not only
11 the cost justification for a given price, but also the entire context within which the
12 price was developed. For example, in its Docket No. R2000-1 discussion of
13 single-piece First-class Mail rates, the Commission considered the effect of the
14 rate on the Postal Service's revenue, the relative growth rates of single-piece
15 and workshared First-class Mail, relative rate increases, rate increases
16 compared to the rate of inflation, rate changes as compared to those of other
17 classes of mail, as well as simplicity. PRC Op. R2000-1 at 233-235. **A**
18 mechanistic assertion that "discounts should always equal costs avoided" or that
19 "only economically efficient rates should be adopted" fails to consider the myriad
20

- 1 of factors that must be considered in constructing postal rates that are both fair
- 2 and equitable and consistent with the Act.²

² Pitney Bowes witness Panzar makes an interesting point, acknowledging that his

testimony sets forth the arguments in favor of instituting a system of cost-based discounts at the subclass level. ~~It~~ It does not specifically address the issue of how one makes changes from an existing system of discounts that are less than avoided costs.

Tr. 26/9159, response to USPSIPB-TI-5.

1 III. THE PROPOSED FIRST-CLASS MAIL RATES ARE REASONABLE AND
2 CONSISTENT WITH THE ACT

3 In evaluating any postal rate proposal, the basic (single-piece, first-ounce)
4 First-class Mail rate (in this docket proposed to be 42 cents) is a keystone rate
5 which is inextricably tied to the Postal Service's revenue requirement and policy
6 goals. In the base year, this rate was the largest single contributor to postal
7 revenues, accounting for \$15.9 billion, or 22.8 percent of the Postal Service's
8 total postage and fee revenue. In FY 2005, the basic First-class Mail rate alone
9 provided almost \$2 billion more revenue than the combined revenue from
10 Express Mail, Priority Mail, Periodicals, Parcel Post, Bound Printed Matter, Media
11 Mail, Library Mail, International Mail, and Special Services. USPS-LR-L-77.

12 In Docket R2000-1, the Commission noted several factors that the Postal
13 Service also has considered in developing the proposed 42-cent First-class Mail
14 basic rate in this docket:

15 Recommending the single-piece First-class rate entails balancing several
16 unpleasant choices. . . . [E]ach penny of this rate affects hundreds of
17 millions of dollars in Postal Service revenue that would otherwise be
18 assessed to other mail classes. Balancing this is the already high
19 institutional cost contribution of First-class mailers. On the other hand,
20 the [Postal Service's proposed Docket No. R2000-1] rate increase for
21 First-class Mail is in line with inflation, and is lower on a percentage basis
22 than the system wide rate increase.

23 PRC Op. R2000-1 at 235.

24 The process of developing the basic First-class Mail rate is unique given
25 its importance in meeting the revenue requirement of the Postal Service. In my
26 experience, the initial steps of rate design focus on what the test year revenue
27 requirement is, and how that revenue requirement will affect the proposed basic

1 First-class Mail rate. The policy implications of no other proposed rate are as
2 carefully considered as those surrounding the basic First-class Mail rate.

3 In this docket, Postal Service witness Taufique (USPS-T-32) has
4 proposed that the basic First-class Mail rate increase from 39 cents to 42 cents,
5 a 7.7 percent change, which is less than the average percentage change for the
6 system as a whole. Exhibit USPS-31D. In fact, the basic First-class Mail rate
7 will have increased by less than the rate of inflation over the period since Docket
8 No. R94-1,³ a modest increase which is consistent with the Postal Service's
9 policy goals.

10 In discussing the Postal Service's proposals, intervenor witnesses Kobe
11 (APWU-T-I), and Clifton (GCA-T-1)⁴ propose changes to the basic First-class
12 Mail rate which they "finance" by either reducing the proposed discounts for --
13 and thus further increasing the rates of -- presorted First-class Mail (APWU-T-1
14 at Table 2) or by increasing Standard Mail rates (GCA-T-1 at 60).⁵ In each case,

³ Beginning with the Docket No. R94-1 rates implemented in January 1995, the basic First-class Mail rate will have increased from 32 cents to the proposed 42 cents, or 31.3 percent. USPS-LR-L-73. Over the period January 1995 to October 2006 (approximately 7 months short of the expected Docket No. R2006-1 May 2007 implementation date), the CPI-U has increased 34.0 percent. Bureau of Labor Statistics, www.bls.gov, Series ID: CUSROOOOSAO.

⁴ GCA witness Clifton's revision of the Postal Service's elasticity estimates is discussed by witness Thress. USPS-RT-2.

⁵ While OCA witness Thompson accepts the Postal Service's proposed 42-cent rate, the revenue effect of her proposal to eliminate the additional ounce rate structure is offset by an increase in presorted First-class Mail rates. OCA-T-1 at 3, line 7. In rebuttal, Postal Service witness Taufique (USPS-RT-18) discusses the Postal Service's concerns about OCA witness Thompson's proposal and its potential effect on First-class Mail rates. In addition, OCA witness Thompson's proposal fails to recognize the increased value of service that a customer receives when they send heavier weight First-class Mail pieces.

0 1 these proposals fail to recognize the dynamics that support the Postal Service's
2 2 proposal and the policy implications of deviations from that proposal.

3 3 If the Postal Service's proposed increase in the First-class Mail basic rate
4 4 from 39 to **42** cents were to be reduced, the Postal Service would have to
5 5 recover substantial additional revenue from other customer groups. APWU
6 6 witness Kobe has chosen to recover this revenue shortfall entirely from presorted
7 7 First-class Mail. She rationalizes this decision by initially invoking a rate design
8 8 based on Efficient Component Pricing, as indicated by 100% passthroughs of
9 9 avoided cost estimates based on the Bulk Meter Mail benchmark. APWU-T-1 at
10 10 9. While this use of ECP may, at first blush, be appealing, it fails to recognize a
11 11 number of factors which underlie the Postal Service's initial policy decision to
12 12 propose presorted First-class Mail price increases that are slightly less than the
13 13 average percent change.⁶

14 14 Economic efficiency,' or ECP as used by APWU witness Kobe and
15 15 applied to presorted First-class Mail rates, is not a static concept and cannot be
16 16 evaluated without considering the underlying changes in unit **costs** over time.
17 17 From FY 1997 to FY 2005, the Postal Service's unit costs for presorted First-
18 18 Class Mail have increased from 9.8 cents to 10.1 cents in base year 2005.
19 19 USPS-RT-18 at Table 2. This is a unit cost increase of only 3.6 percent over a

⁶ Interestingly, despite her arguments supporting 100 percent passthroughs, by choosing greater than 100 percent passthroughs to mitigate "rate shock", APWU witness Kobe recognizes that rate design is not a simple exercise of calculating would-be economically efficient rates. APWU-T-1 at 10, lines 9-10.

⁷ ECP is not the sole determinant of efficiency. In prior dockets, intervenors have invoked Ramsey pricing or similar rate design approaches in the name of economic efficiency. See, for instance, **PRC** Op. R97-1 at 239.

1 period during which the unit cost for single-piece First-class Mail increased 21.1
 2 percent.' Id. This cost trend reflects several factors, including the Postal
 3 Service's decision in the early 1990's to target its automation program at letter-
 4 shaped mail, with the result of considerable success in slowing the increase in
 5 processing costs not only for workshared mail but also for single-piece First-
 6 Class Mail. While some credit for this is due to increased worksharing
 7 encouraged by the classification reform discounts implemented in 1996, this
 8 trend has continued. From FY 2000 to FY 2005, unit volume variable costs have
 9 increased 10 percent for single-piece First-class Mail while presorted First-class
 10 Mail costs have increased only 3 percent. Id. In comparison, average revenue
 11 has increased 9 percent for single-piece and 11 percent for presorted First-class
 12 Mail.⁹ As a result, the implicit cost coverage and per-unit contribution for
 13 presorted First-class Mail continue to rise. Tr. 16/4915; response to
 14 MMA/USPS-T32-2. This has resulted in a high relative contribution to the Postal
 15 Service's institutional costs with an implicit cost coverage exceeding 300 percent
 16 for presorted First-class Mail. See Exhibit USPS-31B. In effect, by applying a
 17 single concept and effectively ignoring the statutory criteria, APWU witness Kobe

⁸ FY 1997 was chosen as a starting point because this is the first full fiscal year following the implementation of the Docket No. MC95-1 reclassification rates.

⁹ The increase in presorted revenue per piece is greater than the increase in single-piece revenue per piece despite an increase in the degree of customer worksharing. In FY 2005, 84.8 percent of all presorted mail was entered as 3-digit, 5-digit, or carrier route automation presorted letters and flats. USPS-LR-L-77. In FY 2000, 78.8 percent of all presorted mail was entered as 3-digit, 5-digit, 3/5-digit, or carrier-route automation presorted letters and flats. USPS-LR-J-98.

1 is asking the Commission to penalize presorted First-class Mail – the mail
2 category with the most stable costs – with a higher-than-average increase.

3 As has been discussed in previous dockets, the Postal Service is
4 concerned about the potential impact on these First-class Mail customers,
5 whose mail preparation activities have played a large part in the success of our
6 automation program. In addition, the Postal Service is concerned about the
7 equity implications of imposing higher-than-average price increases on a
8 customer group whose costs in recent years have been substantially stable.
9 While theories based on economic efficiency often inform Commission decisions
10 “[t]he language of the Act does not specifically identify the pursuit of economic
11 efficiency as a policy objective.” PRC Op. R97-1 at 237. Section 3622(b)(1)
12 does, however, require that the Commission recommend fair and equitable rates.
13 In contrast, APWU witness Kobe, while discussing the results of Efficient
14 Component Pricing at length, does not determine whether her price proposal to
15 shift the revenue burden to presorted First-class Mail is “fair and equitable.” The
16 following interrogatory response is telling:

17 NAPM/APWU-T1-1

18

19 a. Please confirm that discounts set at 100 percent of avoided costs are
20 both fair and equitable. If you cannot confirm, please explain why.

21

22 Response:

23 a. Fair and equitable as used in postal rate proceedings is, as I
24 understand it, a legal concept contained in the PRA and I am not a lawyer.
25 As I stated in my testimony, setting discounts equal to costs avoided

1 provides a basis for ensuring that a piece of mail would pay the same
2 contribution to overhead whether or not it is workshared.

3 Tr. 20/7131. The Commission does not have the luxury of applying a theory
4 without considering its consistency with the policies of the Act.

5 Witness Clifton (GCA- 1) also testifies in support of reducing the Postal
6 Service's proposed increase in the basic First-class Mail rate to 41 cents. In
7 contrast to APWU witness Kobe, GCA witness Clifton proposes that Standard
8 Mail would be the appropriate target to finance his proposal. GCA-T-1 at 59.
9 However, a review of witness Clifton's proposal does not provide the
10 Commission with any reasoned guidance about the relative merits of his
11 proposal versus any alternative. First, it is unclear what witness Clifton's
12 proposal is. It could be to limit the increase in the basic single-piece First-class
13 Mail rate for letter-shaped mail to 41 cents (hereinafter, "Clifton Option 1"). GCA-
14 T-1 at 59, lines 18-21. It could be to reduce all single-piece and presorted, First-
15 Class Mail, first-ounce rates for letter-shaped mail by one cent from the Postal
16 Service's proposal (hereinafter, "Clifton Option 2").¹⁰ GCA-T-1 at 59 (line 21) –
17 60 (line 2).

18 Second, it appears that GCA witness Clifton may have substantially
19 understated the revenue effect of Clifton Option 2. Given the assumption that

¹⁰ The assumption that GCA witness Clifton's proposal would apply only to letter-shaped mail appears to be most consistent with his oral testimony:

Q. [Mr. Levy] Is it your intention to apply the broader version of your proposal to parcels and flats as well?

A. [Mr. Clifton] It's not my intention to do that.

Tr. 29/9961, lines 1-3.

1 the proposed rate for each First-class Mail piece (both single-piece and
2 presorted) would be reduced by one-cent, a net First-class Mail revenue **loss** of
3 only \$519 million (Tr.29/9799, response to DMA/GCA-T1-7) cannot be correct.
4 In my Appendix below, I estimate that the First-class Mail revenue reduction
5 from Clifton Option 2 is approximately \$812 million.”

6 Third, GCA witness Clifton’s intended target for recovering this revenue is
7 also unclear. He proposes that the Commission “raise rates on Standard A
8 Regular mail to maintain revenue neutrality;” (GCA-T-1 at 60, lines 15-16);
9 however, his calculations presented in the response to DMA/GCA-T1-7 (Tr.
10 29/9799) seem to indicate that both Standard Mail Regular and Standard Mail
11 Nonprofit would bear the burden. While “Standard A Regular” may have been
12 merely a shorthand description of the affected subclasses, the policy implications
13 are not trivial. The requirements of § 3626 tie Standard Mail Nonprofit revenue
14 per piece to Standard Mail Regular revenue per piece. Therefore: witness
15 Clifton’s proposal would also place upward pressure on Standard Mail Nonprofit
16 rates.

17 Under the Postal Service’s proposal, Standard Mail Regular rates
18 increase by an average of 9.6 percent which is more than the system average,.
19 The proposed 8.9 percent Standard Mail Nonprofit average rate increase is also
20 above the system average. Exhibit USPS-31D, revised 8/25/2006. Clifton

¹¹ For the sake of simplicity, I have assumed no volume effect in either Standard Mail or First-class Mail. This is consistent with the hypothetical proposed in DMA/GCA-T1-7, Tr. 29/9794-9799. Consider also that a strict focus on revenue neutrality may not highlight potential contribution issues inherent in such a proposal.

1 Option 1 would reduce single-piece First-class Mail revenue by approximately
2 \$337 million (Tr. 29/9796; response to DMA/GCA-T1-7) and result in an average
3 Standard Mail Regular rate increase of 11.8 percent and an average Standard
4 Mail Nonprofit rate increase of 11.0 percent. Clifton Option 2 would reduce First-
5 Class Mail revenue by approximately \$813 million and result in an average
6 Standard Mail Regular increase of 14.8 percent and an average Standard Mail
7 Nonprofit rate increase of 14.0 percent. See my Appendix below. Apparently, in
8 GCA witness Clifton's view, either option is reasonable, and it is not necessary to
9 reconsider whether his revision results in rates that are still consistent with the
10 pricing criteria.

11 In addition to determining what **cost** coverages and associated rate
12 increases should be recommended, the Commission must recommend rates and
13 determine which of many smaller rate categories will bear the burden of the rate
14 increase. In his direct testimony, Postal Service witness Kiefer (USPS-T-36) has
15 carefully developed a rate proposal that balances many competing criteria. In
16 contrast, GCA witness Clifton provides the Commission with no guidance on how
17 it should impose the additional rate and revenue burden arising from his
18 proposals. Should relatively efficient automation letters pay higher rates? Or will
19 the additional increase be imposed on flats and parcels for which the Postal
20 Service already has proposed greater-than-average rate increases? All of these
21 decisions have policy implications that GCA witness Clifton chooses to ignore.

22 In his discussion of the application of the pricing criteria to Standard Mail,
23 Postal Service witness O'Hara justifies his proposed greater-than-average rate

1 increase by carefully examining the characteristics of Standard Mail Regular
2 service and assessing how the statutory pricing criteria inform his determination
3 that the proposed rate increase and cost coverage are reasonable and
4 consistent with the Act. USPS-T-31 at 27-28. **GCA** witness Clifton simply
5 asserts his result is appropriate, based on a flawed elasticity model which is
6 discredited by witness Thress. USPS-RT-2.

1 IV. UPS WITNESS GEDDES' PROPOSED PRIORITY MAIL RATE
2 INCREASE IS UNREASONABLE

3 UPS witness Geddes (UPS-T-3) proposes an unreasonable 23.6 percent
4 increase in Priority Mail rates. UPS-T-3 at 12. While witness Geddes discusses
5 the pricing criteria at length, his analysis is seriously flawed by his failure to
6 address a fundamental fact of rate design – customers pay prices, not markups,
7 not cost coverages, nor markup indices. Therefore, while he discusses markups
8 and markup indices at length, witness Geddes fails to provide the market and
9 rate context needed to inform the Commission's recommended decision.

10 Postal Service witness O'Hara has proposed a 13.6 percent increase in
11 Priority Mail rates based on his assessment of the pricing criteria. Exhibit USPS-
12 31D, revised 8/25/2006. This increase is substantially above the system-
13 average increase of 8.5 percent and, in light of recent Priority Mail rate history, a
14 further increase is not warranted. Assuming implementation of the Postal
15 Service's proposal, Priority Mail rates will have increased 19.7 percent over
16 eighteen months, and 59.3 percent¹² in this decade. Rate increases of this
17 magnitude raise serious concerns about the impact on customers of the Postal
18 Service and the need to mitigate Priority Mail rate increases, to the extent
19 possible, given cost trends,

¹² This is the cumulative effect of the currently proposed 13.6 percent rate increase, the 5.4 percent Docket R2005-1 rate increase, the 13.5 percent Docket No. R2001-1 increase and the 17.2 percent Docket No. R2000-1 rate increase. See, Exhibit USPS-31D; Dockets R2005-1, R2001-1, PRC Op. Appendix G at 1; and Decision of the Governors of the United States Postal Service on the Recommended Decision on Further Reconsideration of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R2000-1.

1 Despite the substantial increase in Priority Mail rates, UPS witness
 2 Geddes suggests that Priority Mail volume “can recover from a series of
 3 unfortunate events and rate increases.” UPS-T-3 at 17. This argument is based
 4 on a Priority Mail growth rate of 5 percent in FY 2005 and preliminary data for FY
 5 2006 that suggest continued growth. He further states that,

6 Because Priority Mail volume growth rates are approaching the historical
 7 growth rate after seven quarters, I do not believe that permanent or
 8 systemic factors have reduced the long-term competitiveness of Priority
 9 Mail.

10 Tr. 26/9121, response to USPS/UPS-T3-5. Once again, context is lacking in this
 11 analysis. From FY 2000 to FY 2005, Priority Mail volume fell from 1,222 million
 12 to 887 million pieces – a reduction of 27 percent. USPS-LR-L-77. Despite UPS
 13 witness Geddes’ assertion that “Priority Mail volumes have recovered” [Tr.
 14 26/9120; response to USPS-UPS-T3-4); assuming that the very recent 5 percent
 15 average annual growth rate persists, Priority Mail volumes will not reach the FY
 16 2000 level for almost another seven years.¹³ In contrast, from 2000 through
 17 2004, UPS combined deferred and ground volume grew by 2.1 percent .
 18 Response to USPS/UPS-T3-7, redirected to UPS.

19 The Postal Service’s market share has dropped from “over 70 percent of
 20 the second-day delivery market” (PRC Op. R94-1 at ¶5116) to 53.1 percent in FY
 21 2004 (USPS-T-33 at 8).¹⁴ UPS witness Geddes generally argues that cost

¹³ From a FY 2005 volume of 887 million pieces, volume will not exceed FY2000 volume (1,222 million pieces) for 6.6 years. That is, $(887 \text{ million pieces}) \cdot (1+5\%)^{\wedge} 6.6 \text{ years} = 1,224 \text{ million pieces}$.

¹⁴ As Postal Service witness Scherer indicates, these data overstate the Postal Service’s true market position. USPS-T-33 at 8.

coverage should not be lowered in order to protect the Postal Service's market share. UPS-T-3 at Section III.D. However, the principles that the Commission used in its Docket No. R2000-1 decision still hold today:

The Commission finds it appropriate to moderate Priority Mail's coverage to this level in order to protect its users – especially those users whose mail falls within the monopoly segment of Priority Mail – from the impact of even higher rate levels. It is also the Commission's opinion that restraining coverage to this level is appropriate under § 3622(b)(5) to avoid the harm that higher rate levels may cause the Postal Service's position as a competitor in the market in which Priority Mail competes. The Commission rejects the suggestion of United Parcel Service that this is an impermissible or negligible consideration in formulating pricing recommendations.

PRC Op. R2000-1 at 313 [footnote omitted]. These principles do not argue for the adoption of the Docket No. R2000-1 cost coverage in the current case, but rather a careful consideration of the competitive conditions surrounding every rate request, as well as the importance of considering the effect of any price increase on the Postal Service's customers.

UPS witness Geddes suggests that the Commission recommend a cost coverage for Priority Mail of 163 percent because (1) it is close to that recommended by the Commission in Docket No. R2000-1; and (2) it is that proposed by the Postal Service in this docket. UPS-T-3 at 12. UPS witness Geddes further suggests that "the best recommended cost coverage is not dependent upon the cost basis utilized." Tr. 26/9122; response to USPS/UPS-T3-6. While asserting that he has assessed his proposed coverages in light of the pricing criteria, witness Geddes does not appear to understand that cost coverages can be evaluated using the pricing criteria only within the entire context of the resulting rate proposal. If the underlying costing methodologies

1 are not consistent, then comparing resulting cost coverage “numbers” is of little
2 value. As has been discussed at length, the costing methodology proposed by
3 the Postal Service in this case differs from the costing methodology used by the
4 Commission in prior Recommended Decisions. As a result, the same rate
5 increase when compared to each of the *two* different cost methodologies will
6 result in different cost coverages without changing the underlying rates.”
7 Although cost coverages, and the many factors that underlie them, provide
8 useful guidance to the Commission, the Commission’s obligation is not simply to
9 recommend cost coverages.

¹⁵ This is most readily illustrated by the results of Docket No. R2005-1. For Priority Mail, the Commission recommended rates identical to those proposed by the Postal Service. PRC Op. R2005-1 at 122. However, the calculated Priority Mail cost coverage based on the PRC costing methodology was 140.1 percent (PRC Op. R2005-1, Appendix G at 1) as compared to the calculated Priority Mail cost coverage of 156.5 percent (Docket No. R2005-1, Exhibit USPS-27B, revised 6/10/2005) based on the Postal Service’s costing methodology

1 V. VALPAK WITNESS MITCHELL'S STANDARD MAIL PROPOSALS ARE
2 ILL-CONCEIVED

3 In this docket, a number of intervenor witnesses have suggested rate
4 designs which rely heavily on the theory of Efficient Component Pricing. The
5 Commission has long recognized the value of postal rates and fees that reflect
6 cost-causative characteristics and encourage economic efficiency. As I discuss
7 above, the Postal Service has generally agreed with the Commission's
8 conclusions about the value of economically efficient rates as well as the need to
9 temper recommendations based on economic efficiency with a reasoned
10 assessment of all of the pricing criteria. Valpak witness Mitchell's proposals
11 highlight the danger of an overly narrow focus on economic efficiency at the
12 expense of considerations of all other factors¹⁶.

13 Witness Mitchell (VP-T-1) begins his discussion of Standard Mail rates
14 and rate design with an assessment of changes in the postal market over the last
15 eight years.

16 During this period [since Docket No. R2000-1], postal operations have
17 changed, mail preparation has changed, and the capabilities of the Postal
18 Service and mailers have changed, not to mention changes in markets
19 and the competitive environment. One would expect recognition of these
20 changes, particularly in costs, to require numerous and significant rate
21 adjustments.

22 VP-T-1 at 6 (line 15) – 7 (line 4). Despite his assessment that the postal
23 landscape has changed, Valpak witness Mitchell continues to contend that the
24 Commission should:

¹⁶ Postal Service rebuttal witness Kiefer discusses numerous flaws with witness Mitchell's Standard Mail rate proposals. USPS-RT-11.

1 take the steps understood at the time the *two* [commercial Standard Mail]
2 subclasses were created and adjust the markups and the rates
3 accordingly.

4 VP-T-1 at 12, lines 12-14. In other words, witness Mitchell believes that the
5 Commission should return to a view of Standard Mail pricing that may (or may
6 not) have existed in 1996.

7 Valpak witness Mitchell does not appreciate that theoretical arguments
8 about what the "perfect" cost coverage should be must be tempered with a
9 realistic assessment of how changes in cost coverage affect not only the rates
10 and cost coverages recommended for Standard Mail ECR, but also those
11 recommended for other subclasses, and the revenue requirements of the Postal
12 Service as a whole. The Commission, in its recommended decisions, has
13 repeatedly considered the Postal Service's proposals, Valpak's proposals, and
14 the proposals of numerous other intervenors, and determined that the
15 recommended rates, including Standard Mail ECR rates, are fully consistent with
16 the pricing criteria and other provisions of the Act. To quote witness Mitchell,

17 The Commission has clearly given weight to ECP, notions of lowest
18 combined cost, worksharing, the signal sent to mailers, how competition
19 should be recognized, how products should be defined, the capabilities of
20 mailers, elasticity, issues of resource allocation, costing theory long run
21 vs. short run, notions of cross subsidy, questions of when mailers are
22 similarly situated, ease of administration, and others, none of which is
23 addressed specifically in the Act. . . . The practice of giving weight *to* such
24 concerns should continue.

25 VP-T-1 at 55. The Postal Service's rate proposal does exactly that, it balances
26 all of the pricing criteria to develop rates which meet the Postal Service's
27 revenue requirement. See USPS-T-31 at 29-30.

1 Valpak witness Mitchell proposes that Standard Mail ECR rates should
2 decrease by 8.47 percent while Standard Mail Regular rates should increase by
3 17.56 percent. VP-T-1 at 97. Witness Mitchell also suggests an alternate set of
4 cost coverages in the event that Congress does not enact legislative changes to
5 the current postal price-setting system embodied in Title 39. VP-T-1 at 97.
6 Witness Mitchell seems to leave the Commission with an odd choice. The
7 Commission could choose the (unspecified) rates that witness Mitchell would
8 recommend if everything were just as it is today, or it could speculate, and
9 prejudge how it might implement a yet-to-be-enacted legislative proposal.
10 Witness Mitchell presumes, with little foundation, that this speculation would lead
11 to the rates he has designed.

12 More reasonably, the Postal Service's proposal offers the Commission a
13 balanced assessment of the pricing criteria and presents a comprehensive
14 pricing proposal that not only considers how prices for Standard Mail ECR
15 should be developed but also how the Standard Mail ECR price proposal fits
16 within the context of rate proposals for all mail subclasses. Valpak witness
17 Mitchell's proposal raises fundamental questions about why Standard Mail ECR
18 should be granted preferential price treatment as compared to all other
19 subclasses of mail.¹⁷ Under the Postal Service's proposals, only First-class Mail
20 Letters and Sealed Parcels has a lower rate increase (7.1 percent) than
21 Standard Mail ECR (8.9 percent). This is despite the fact that Standard Mail

¹⁷ Valpak witness Mitchell does not propose changes to the Postal Service's proposal for any class of mail other than Standard Mail. Tr. 25/8936, response to USPS/VP-T1-28(f).

1 ECR pays lower rates than any non-preferred mail; and, in comparison to
 2 Standard Mail Regular, Standard Mail ECR pays approximately the same per-
 3 piece contribution to institutional costs as Standard Mail Regular. See USPS-T-
 4 31 at 30.

5 Valpak witness Mitchell continues to assert that, somehow, the goals of
 6 Docket No. MC95-1 have not been achieved, because the cost coverage for
 7 Standard Mail ECR has not been reduced below that of Standard Mail Regular.
 8 He cites the Commission's paraphrasing of Postal Service witness Moeller's
 9 Docket No. MC95-1 argument that ECR cost coverage should be lower (see, for
 10 example, VP-T-1 at 29 lines 6-12); however, witness Mitchell does not provide
 11 any direct evidence that the Commission has established a long-term policy
 12 aimed at reducing Standard Mail ECR cost coverages to the levels he
 13 suggests." In fact, in its first opportunity to adjust Standard Mail ECR cost
 14 coverages following Docket No. MC95-1:

15 [t]he Commission . . . [agreed] with the Service that even though several
 16 of the statutory factors might indicate a low ECR cost coverage, on
 17 balance the record supports an ECR cost coverage that is well above
 18 average.

19 PRC Op. R97-1 at 447. In its Docket No. R97-1 recommended decision, and in
 20 each subsequent recommended decision, the Commission has balanced the

¹⁸ However, **the** Commission has recommended relatively small rate increases for Standard Mail ECR since Docket No. MC95-1. Over this period, Standard Mail ECR rates have increased 21.1 percent, less than the system average 23.6 percent. In contrast, Standard Mail Regular rates have increased 26.8 percent. See Dockets R2005-1, R2001-1, PRC Op. Appendix **G** at 1; and Decision of the Governors of the United States Postal Service on the Recommended Decision on Further Reconsideration of the Postal Rate Commission on Postal Rate and Fee Changes, Docket No. R2000-1.

often conflicting factors embodied in the pricing criteria and reached the
2 conclusion that a greater-than-average Standard Mail **ECR** cost coverage is
3 consistent with the Act. In its current proposal, the Postal Service has carefully
4 weighed the statutory pricing criteria and provided substantial evidence
5 supporting the conclusion that a greater-than-average Standard Mail ECR cost
6 coverage is justified. This proposal should be accepted.

Appendix to **USPS-RT- 10**

<u>First-Class Mail</u>		TYAR	TYAR (Clifton 1)	TYAR (Clifton 2)
Letter-shaped mail pieces				
(a)	Single-piece, excl. QBRM	33,401,815	33,401,815	33,401,815
(b)	QBRM	322,989	322,989	322,989
(c) = (a) + (b)	Total Single-piece letter-shaped	33,724,804	33,724,804	33,724,804
(d)	Nonautomation presort	840,022		840,022
(e)	Mixed AADC	2,918,778		2,918,778
(f)	AADC	2,538,198		2,538,198
(g)	3-Digit	23,024,390		23,024,390
(h)	5-Digit	18,233,989		18,233,989
(i) = (d) + (e) + (f) + (g) + (h)	Total Presorted Letter-shap	47,555,377		47,555,377
(j) = (c) + (i)	Total letter -shape	81,280,181		81,280,181
(k)	Assumption Reduction in rate		\$ 0.01	\$ 0.01
(l)	Assumption Volume Affected		33,724,804	81,280,181
(m) = (k) * (l)	Reduction in revenue		337,248	812,802
<u>Standard Mail</u>				
Revenue		TYBR	TYAR	N A R (Clifton 1) TYAR (Clifton 2)
(n)	Standard Mail Regular	14,062,934	15,525,041	15,826,678
(o)	Standard Mail Nonprofit	1,695,668	1,832,884	1,868,496
(p) = (n) + (o)	Total Standard Regular & Nonprofit	15,758,600	17,357,925	17,695,174
Volume				
(q)	Standard Mail Regular	62,380,254	62,815,558	62,815,558
(r)	Standard Mail Nonprofit	12,464,101	12,372,554	12,372,554
(s) = (q) + (r)	Total Standard Regular & Nonprofit	74,844,355	75,188,113	75,188,113
Revenue per piece				
(t) = (n) / (q)	Standard Mail Regular	\$ 0.225	\$ 0.247	\$ 0.252
(u) = (o) / (r)	Standard Mail Nonprofit	\$ 0.136	\$ 0.148	\$ 0.155
(v) = (p) / (s)	Total Standard Regular & Nonprofit	\$ 0.211	\$ 0.231	\$ 0.235
Percentage Change Revenue Per piece				
(w)	Standard Mail Regular		9.6%	11.8%
(x)	Standard Mail Nonprofit		8.9%	11.0%
(y)	Average percentage change		9.6%	11.8%

Notes:

Rows (a) - (j) USPS-LR-L-129 revised 8/24/2006
 Row (l) column (3) Assumption that rate reduced for single-piece FCM letter shape only
 Row (l) column (4) Assumption that rate reduced for all FCM letter-shape
 Rows (n) column (1) - (2) USPS-LR-L-36, revised 6/21/2006
 Row (n), column (3) - (4) [Row (n) column (2) + row (m)] * row (n) col (2) / row (p) col (2)
 Rows (o) column (1) - (2) USPS-LR-L-36, revised 6/21/2006
 Row (o), column (3) - (4) [Row (o) column (2) + row (m)] * row (o) col (2) / row (p) col (2)
 Note: row (n) - (o) assume that revenue is collected pm rate on revenue from Reg and NP
 Rows (q) - (r) USPS-LR-L-36, revised 6/21/2006

1 CHAIRMAN OMAS: This now brings us to oral
2 cross-examination. Four parties have requested oral
3 cross-examination.

4 Greeting Card Association, Mr. Horwood?

5 CROSS-EXAMINATION

6 BY MR. HORWOOD:

7 Q Good morning, Ms. Robinson. I am James
8 Horwood representing the Greeting Card Association.

9 A Good morning.

10 Q I'd like to refer you to page 12 of your
11 testimony. In the sentence that's on lines 11 to 12
12 you say that first, it is unclear what Witness
13 Clifton's proposal is.

14 Do you have Witness Clifton's testimony in
15 front of you?

16 A No, I don't.

17 MR. HORWOOD: Counsel, if I might just hand
18 her an extra copy?

19 BY MR. HORWOOD:

20 Q Please turn to page 59. Please read into
21 the record the paragraph that starts on line 16 of
22 page 59 that carries over to the top of page 60.

23 A Okay. This is Witness Clifton's testimony,
24 GCA-T-1, I believe.

25 Q That's correct.

1 A Starting on line 16, page 59.

2 Q Right.

3 A "For this case, I propose that the
4 Commission increase the unit contributions made by
5 standard A regular mail sufficiently to reduce the
6 rate increase on first class single piece letters from
7 42 to 41 cents.

8 "Under delinking, this proposal should not
9 impact the rates or discounts proposed by the Postal
10 Service for first class workshare mail at all, and I
11 do not propose any change in those rates from what
12 USPS has proposed.

13 "Under a continuation of linked rates, I
14 propose that each of the first ounce letter rates for
15 the FCLM subclass be reduced by one cent compared to
16 USPS rate proposals in order to keep the USPS proposed
17 discounts as measured from single piece under linking
18 the same."

19 Q You say in your testimony that's unclear.
20 What is unclear about that statement?

21 A Mr. Clifton has proposed what appears to me
22 to be two different proposals, one in which the single
23 piece first class mail rate proposed to be 42 cents be
24 reduced to 41 cents. The second proposal is that all
25 first class mail rates be reduced by one cent, as far

1 as I can tell.

2 What seems to be unclear is which option Mr.
3 Clifton is proposing that the Commission consider.

4 Q Isn't Mr. Clifton saying that if there's
5 going to be delinking, which is what's been proposed
6 by parties, he has one proposal, but if linking is
7 continued then his proposal would have to be
8 different?

9 A I think that is what he's saying, but the
10 difference between those two proposals in terms of the
11 revenue impact and the contribution impact for the
12 Postal Service is substantial, and I don't think it
13 presents the Commission with a clear choice of what
14 the options are.

15 Q To your knowledge, does Mr. Clifton's
16 testimony make a recommendation as to whether there
17 should be delinking or continued linking?

18 A I believe Mr. Clifton was arguing for a rate
19 design that was more typical of prior cases, what has
20 been sometimes termed linked, I suppose, for lack of a
21 better word.

22 Q What's your basis for that belief?

23 A As I said, that's my recollection of his
24 testimony.

25 Q What is the Postal Service proposing with

1 respect to linking in this case, very generally?

2 A Mr. Taufique's testimony has proposed that
3 the Postal Service rate design for first class mail be
4 based in part on an assessment of the average
5 contribution from single piece mail as compared to
6 presort being approximately the same.

7 Q And that is a delinked proposal, is that
8 right, in terms of how linking has been applied in the
9 past?

10 A Yes, it has been termed that.

11 Q Staying with page 12 of your testimony, on
12 the sentence that begins on line 18 you say second, it
13 appears that GCA Witness Clifton may have
14 substantially understated the revenue effective what
15 you characterize as Clifton Option 2.

16 When you say that Witness Clifton may have
17 substantially understated. Does that mean that he
18 also may not have substantially understated?

19 A As I understand Mr. Clifton's proposal, if
20 you are reducing the first ounce rate for all first
21 class mail, both single piece and presort, I believe
22 he has understated that.

23 However, from his analysis it's not exactly
24 clear to me how he reached the number, the \$500
25 million impact that he estimated for that.

1 Q Okay. We'll come back to that in a minute.
2 Look on page 13. On lines 4 to 5 you state that in
3 your appendix you estimate that the first class mail
4 revenue reduction from what you characterize as
5 Clifton Option 2 is approximately \$812 million, and
6 then you have a Footnote 11 that says, "For the sake
7 of simplicity, I have assumed no volume effect in
8 either standard mail or first class mail," and you
9 state this is consistent with the hypothetical
10 proposed in DMA/GCA-T-1-7.

11 Could you please refer to Dr. Clifton's
12 response to DMA/GCA-T-1-7? For the benefit of the
13 record, that appears at page 9785 of the transcript.
14 I'm sorry. Not 9785. 9794.

15 In that question the reference is made to,
16 "Please refer to your response to DMA/GCA-T-1-1." Are
17 you familiar with Dr. Clifton's response to
18 DMA/GCA-T-1-1?

19 A I have read it.

20 Q Okay. In that response do you recall him
21 stating that the task of estimating these rates was
22 beyond the scope of his testimony?

23 A The task of estimating? I'm sorry. Could
24 you repeat that, please?

25 Q The task of redoing the forecasting model to

1 come up with a calculated effect was beyond the scope
2 of his testimony.

3 A Yes, I believe he stated that the task of
4 reestimating volumes was beyond the scope of his
5 testimony or something to that effect.

6 Q Okay. And do you recall him saying that
7 this would require him to redo the entire Thress
8 forecasting model?

9 A That's generally my recollection.

10 Q Okay. Turning to the response to
11 DMA/GCA-T-1-7, in his response doesn't he begin by
12 stating that the hypothetical was asking him to assume
13 there is no relationship between volume and price?

14 A Yes. In the first two lines of his response
15 he says, "You are asking me in A to assume there is no
16 relationship between volume and price, but my entire
17 testimony contradicts such a premise under the new
18 types of competitive conditions based by single piece
19 letter mail."

20 Q Do you read that answer as him saying that
21 he believes that the hypothetical is an unrealistic
22 hypothetical?

23 A I read that as Dr. Clifton saying that his
24 testimony assumes a relationship between volume and
25 price.

1 Q Do you know whether Dr. Thress' econometric
2 analysis assumes a relationship between volume and
3 price when he runs through the effects of price
4 changes?

5 A I'm going to have to leave the details of
6 his econometric estimates to Witness Thress, but
7 generally I understand there to be a relationship
8 between volume and price in those estimates.

9 Q So it could be described as an interactive
10 relationship?

11 A That's my understanding.

12 Q Have you run an analysis that would be
13 interactive between volume and price?

14 A I have worked with the Postal Service's
15 elasticities as proposed in this case by Witness
16 Thress in order to estimate volume effects associated
17 with price changes.

18 Q Have you done that for purposes of your
19 rebuttal testimony?

20 A No, I have not.

21 Q Okay. Do you believe that the hypothetical
22 that price does not affect volume is a reasonable
23 hypothetical?

24 A No. I think generally if there is a price
25 change there should be a volume effect as well.

1 Q But your testimony here when you calculate
2 the \$812 million effect ignores that relationship. Is
3 that right?

4 A That is correct.

5 Q Do you know whether or not if the change
6 recommended by Dr. Clifton under his proposed Option 2
7 were to be plugged into the Thress model whether the
8 effect would be similar to that as estimated by Dr.
9 Clifton of \$519 million?

10 A Now, you said the effect plugged into
11 Thress' model. Are you speaking of the change in
12 price?

13 Q Yes.

14 A As I generally understand both Witness
15 Thress' model and Dr. Clifton's model, Dr. Clifton's
16 testimony is that there would be a greater volume
17 effect than Witness Thress has suggested.

18 Q Do you know whether that is true with his
19 calculation of the \$519 million?

20 A I don't know how he calculated the \$519
21 million.

22 Q So you don't know whether or not if his
23 recommendation of a one cent change for all first
24 class mail would actually produce something in the
25 neighborhood of \$519 million if run through the Thress

1 model? Is that right?

2 A If run through the Thress model?

3 Q Yes.

4 A I don't believe it would be \$519 million.
5 That sounds very low to me, given the volumes in first
6 class mail and the relative inelasticity of first
7 class mail.

8 Q You haven't done that calculation?

9 A No, I haven't.

10 MR. HORWOOD: Thank you. I have no further
11 questions.

12 CHAIRMAN OMAS: Thank you.

13 Mr. Myers for Pitney Bowes? I'm sorry, Mr.
14 Scanlon. I had Mr. Myers down.

15 MR. SCANLON: That's fine. Michael Scanlon
16 on behalf of Pitney Bowes.

17 CROSS-EXAMINATION

18 BY MR. SCANLON:

19 Q Good morning, Ms. Robinson.

20 A Good morning.

21 Q I want to ask you some questions about your
22 treatment of the testimony of Dr. John Panzar **and his**
23 discussion of efficient component pricing.

24 I want to focus our discussion there because
25 although your critique of the mechanistic application

1 of any particular economic theory has some intuitive
2 appeal, we need to assess whether your testimony
3 accurately reflects Dr. Panzar's testimony in this
4 case.

5 If you could please refer to the Purpose and
6 Scope of your testimony section, the rebuttal
7 testimony at page 1, and in particular I'd like to
8 focus on lines 2 through 9 where you state that,
9 "Witnesses for several Intervenors have proposed
10 prices or pricing approaches different from those
11 proposed in the Postal Service's direct case."

12 You go on to state that, "These Intervenor
13 proposals have at least one element in common. They
14 arise from or result in a flawed assessment of what
15 would constitute acceptable allocation of
16 institutional costs among classes of mail in
17 accordance with the applicable statutory rate making
18 criteria."

19 Is that correct?

20 A Yes, that's what my testimony says.

21 Q And in Footnote 1 at the bottom of page 1
22 the Intervenor witnesses that you reference are APW
23 Witness Kobe, Newspaper Association of America Witness
24 Sidak, Valpak Witness Mitchell and Pitney Bowes
25 Witness Panzar. Is that correct?

1 A Yes, it is.

2 Q Okay. At lines 10 through 13 you go on to
3 state that, "My testimony responds to these
4 alternative proposals and explains why the allocation
5 of institutional costs proposed by Postal Service
6 Witness O'Hara, USPS-T-31, in this case is most
7 faithful to the pricing criteria of the Postal
8 Reorganization Act and why it should be recommended by
9 the Commission." Is that correct?

10 A Yes.

11 Q Okay. Your rebuttal testimony does not
12 provide any citation to Dr. Panzar's written or oral
13 testimony where Dr. Panzar argues for an alternative
14 allocation of institutional costs among classes of
15 mail, does it?

16 A Witness Panzar's testimony discusses the use
17 of efficient component pricing in deriving the rates
18 or discounts. I don't believe he actually discusses
19 what cost coverages for specific classes of mail
20 should be.

21 Q Okay. So he doesn't discuss the allocation
22 of institutional costs at all?

23 A NO.

24 Q Okay. Nor would you expect to find such a
25 discussion in Dr. Panzar's testimony because he

1 discusses the use of efficient component pricing
2 within a subclass. Isn't that correct?

3 A Yes, that's my understanding of his
4 testimony.

5 Q Okay. Now I want to draw a hypothetical I
6 think to illustrate the point. The hypothetical
7 relies on three assumptions.

8 The first assumption is let's assume that
9 the Commission in this case accepts all the Postal
10 Service's cost, revenue and volume estimates without
11 change, okay?

12 A Uh-huh.

13 Q The second assumption is that the Commission
14 decides that the institutional cost coverage among the
15 classes of mail as proposed by Witness O'Hara is
16 exactly right, and therefore the Commission accepts
17 these figures without change as well.

18 Finally, let's assume that the Commission
19 decides that it will adopt a rate design within each
20 subclass that is theoretically a pure application of
21 an efficient component pricing.

22 Even under this hypothetical isn't it true
23 that each class and subclass will make the same
24 contribution to institutional costs as was proposed by
25 the Postal Service?

1 A I think you've assumed that by assuming that
2 the cost coverages at the subclass level would be the
3 same and the costs are the same. I think by
4 definition that's the case.

5 MR. SCANLON: Okay. We have nothing
6 further, Mr. Chairman.

7 CHAIRMAN OMAS: Thank you, Mr. Scanlon.
8 Mr. McKeever?

9 CROSS-EXAMINATION

10 BY MR. MCKEEVER:

11 Q Good morning, Ms. Robinson.

12 A Good morning.

13 Q On page 16 of your testimony at lines 3 to 4
14 you characterize Dr. Geddes' proposed Priority Mail
15 rate increase of 23.6 percent as unreasonable. Is
16 that correct? You use the term unreasonable there?

17 A Yes, I do on line 3, page 16.

18 Q Are you aware that in prior cases the
19 Commission has recommended rate increases greater than
20 that?

21 A You would have to give me a specific
22 example. In the last number of dockets the rate
23 increases have been below that. I am not sure how far
24 back you --

25 Q Well, for example, in R90-1 the Commission

1 recommended a rate increase of 25 percent for what was
2 then called third class bulk regular. Is that
3 correct? Does that sound familiar to you?

4 A My general recollection, having read the R90
5 decision, was there was a relatively large increase
6 for that class mail. I couldn't tell you what the
7 magnitude was.

8 Q Okay. Well, the Commission's decision will
9 show us and I'll represent to you that it was 25
10 percent. We can check that, of course.

11 A I can assume that.

12 Q Okay. Are you aware that the Postal Service
13 has in the past proposed rate increases greater than
14 Dr. Geddes' proposed increase for Priority Mail?

15 A Once again going back to about Docket R97, I
16 don't believe that's the case. In prior dockets, I
17 don't know.

18 Q Do you recall whether in R90-1 the Postal
19 Service proposed a rate increase for parcel post, a
20 competitive service, of 24 percent?

21 A No, I don't know.

22 Q Okay.

23 A I don't recall that.

24 Q Again, the Commission's decision will show
25 it there. I'll represent to you that that is what the

1 Postal Service proposed in that case.

2 In fact, in this case the Postal Service is
3 proposing a 24.2 percent rate increase for Within
4 County periodicals, isn't it?

5 A Yes. Dr. O'Hara proposed a 24.2 percent
6 rate increase for in county periodicals, and that's on
7 his Exhibit USPS-31D.

8 Q And of course 24.2 percent is greater than
9 23.6 percent?

10 A 24.2 is bigger than 23.6.

11 Q I take it that you have read the
12 Commission's decision in R2005-1?

13 A Yes, I have.

14 Q Okay. So you are aware that on the second
15 page of its decision in that case, the last case
16 before this one, the Commission warned that the Postal
17 Service and mailers should expect that in this case
18 there will probably result in unusually
19 disproportionate increases in some rates? Does that
20 sound familiar to you?

21 A I don't remember the particular citation
22 from the Commission's decision.

23 MR. MCKEEVER: With the Chairman's
24 permission, I'd like to present you with a copy of a
25 couple of pages from that decision.

1 (Pause.)

2 BY MR. MCKEEVER:

3 Q Ms. Robinson, I've given you a copy of part
4 of the summary of the Commission's opinion and
5 recommended decision in Docket R2005-1, and I'd like
6 to direct your attention to the second page that I've
7 given you.

8 In particular, about the middle of the page
9 the Commission indicates -- well, let's start first
10 with the second paragraph right at the beginning where
11 the Commission agreed that, "Increases in R2005 to be
12 followed by a proceeding to true up rates after a
13 thorough examination of Postal costs is consistent
14 with sound public policy."

15 Do you see that?

16 A Yes.

17 Q And then later it indicates that its action
18 in R2005 "will probably result in unusually
19 disproportionate increases and decreases in different
20 rates in the next case." That's this case.

21 Do you see that?

22 A Yes. The statement going back to the
23 sentence states, "It," and I assume that's the
24 Commission, "is concerned that the delay in
25 recognizing the impact of recent innovations and

1 improvements in postal operations, coupled with the
2 passage of time, will probably result in unusually
3 disproportionate increases and decreases in different
4 rates in the next case."

5 That to me represents a concern of the
6 Commission, not an indication that disproportionate
7 increases will occur.

8 Q Well, it says "will probably result in
9 unusually disproportionate increases and decreases" in
10 the next case. Isn't that what it says?

11 A Yes, it is.

12 Q That's not a statement that that may occur
13 in this case?

14 A That is a statement. It may occur. It is
15 also not necessarily a prediction that it will occur.

16 Q No, I understand that, but it certainly was
17 concerned and foresaw that those disproportioned
18 increases and decreases will probably result in this
19 case. Is that correct? The case we're now in.

20 A I mean, I can't speak for the Commission,
21 but it appears from this extract that the Commission
22 was concerned about the impact of rate increases upon
23 mailers and particularly the impact of particularly
24 large increases on customers. It's my understanding
25 that the Commission is always concerned with that.

1 Q Sure, and it thought that those increases
2 might have to be disproportionate in this case. Is
3 that correct?

4 A I think it showed that the Commission had a
5 concern over what it characterized somewhat unclearly
6 as disproportionate is something that it needs to be
7 concerned with. The size of the increase is always a
8 concern for the Commission.

9 Q Okay. Well, I guess we'll let the
10 Commission's decision speak for itself then.

11 Could you turn to page 16 of your testimony?
12 At lines 7 to 9 you testify that Dr. Geddes, and I'm
13 quoting here, "fails to provide the market context
14 needed to inform the Commission's recommended
15 decision." Do you see that?

16 A My testimony says, "Therefore, while he
17 discusses markups and markup indices at length,
18 Witness Geddes fails to provide the market and rate
19 context needed to inform the Commission's recommended
20 decision."

21 Q Correct. I just want to focus right now,
22 and we'll get to the rate context, but I just want to
23 focus right now on your statement that Dr. Geddes
24 fails to provide the market context needed to inform
25 the Commission's recommended decision.

1 That's what you testify to. Is that
2 correct?

3 A That is one portion of that sentence, yes.

4 Q Okay I take it you do not have a copy of
5 Dr. Geddes' testimony with you?

6 A No, I don't.

7 MR. MCKEEVER: With the Chairman's
8 permission, I'd like to provide a copy to the witness.

9 (Pause.)

10 BY MR. MCKEEVER:

11 Q NOW could you turn to page 13 of Dr. Geddes'
12 testimony? There at lines 8 to 9 Dr. Geddes states
13 that Priority Mail "is largely a competitive service."
14 Is that correct?

15 A Yes. His testimony on lines 8 to 9, "On the
16 other hand, Priority Mail is largely a competitive
17 service."

18 Q That's a statement about the market. IS
19 that correct?

20 A Yes.

21 Q And could you turn to page 15? At lines 1
22 to 8 he has a paragraph that discusses, and I'm
23 quoting here from his first sentence in that
24 paragraph, "the impact of Priority Mail rates on
25 competition." Is that correct?

1 A Yes, that paragraph discusses the impact of
2 Priority Mail rates on competition.

3 Q Excuse me. I accidentally turned my mic
4 off. I will start over again.

5 On the next page, page 16, starting at line
6 1 he has a paragraph that discusses the fact that, and
7 I'm quoting here, "Priority Mail operates in a highly
8 competitive market." Is that correct?

9 A Yes, that's his statement on line 1, page
10 16.

11 Q He's addressing the nature of the market
12 there?

13 A Yes.

14 Q In fact, in the next sentence he
15 specifically mentions some of the competitors in that
16 market -- UPS, FedEx, DHL and others. Is that
17 correct?

18 A Yes, he does.

19 Q And again on pages 16 and 17 he cites
20 several reasons for Priority Mail's volume decline
21 from 2001 through 2004 and notes that one of those
22 reasons is "increased competition" at the top of page
23 17.

24 A No. The passage you're citing says, "Postal
25 Service Witness Scherer identifies several reasons for

1 the decline, including the rate increase of 2001 and
2 2002, increased competition and the slowing economy,
3 among others." It continues.

4 I understand that to be his paraphrase of
5 Witness Scherer's testimony.

6 Q Yes, but Dr. Geddes points that out that
7 Postal Service Witness Scherer testifies about the
8 market, and this is what he says.

9 A Yes. He's paraphrasing Witness Scherer.

10 Q Yes. Okay. That is in Dr. Geddes'
11 testimony, that paraphrase?

12 A Yes, it is.

13 Q Okay. On pages 18 through 20 Dr. Geddes
14 compares Priority Mail's situation with that of
15 Express Mail, another service where the Postal Service
16 faces competition. Is that right?

17 A On pages 18 to 19 of Dr. Geddes' testimony
18 he discusses Express Mail, pointing out that there are
19 some competitors to Express Mail, and he draws some
20 analogies I suppose between Express Mail and Priority
21 Mail.

22 Q Because they're both competitive services,
23 among other things. Is that correct?

24 Let me refer you to page 20, for example,
25 still in that same section, lines 3 to 4, where Dr.

1 Geddes states the Express Mail experience since R97
2 "indicates that an improvement in markups for a
3 competitive mail class is feasible and appropriate."
4 Do you see that?

5 A Yes, I do.

6 Q On that same page at lines 10 to 11 -- page
7 20 now, lines 10 to 11 -- he notes, and I'm quoting
8 here, "the ability of Priority Mail users to move to
9 alternative suppliers." Is that right?

10 A Yes, he has that phrase there.

11 Q Okay. Alternative suppliers. That's a
12 statement about the market. Is that correct? It
13 indicates that there are --

14 A Generally I would say yes.

15 Q Okay. Now let's look at Dr. O'Hara's
16 testimony. He's the Postal Service witness who, like
17 Dr. Geddes, proposes a cost coverage for Priority
18 Mail, right?

19 A Yes, he does.

20 Q And you of course have read his testimony?

21 A I have.

22 Q Do you have a copy of it with you?

23 A No, I don't.

24 MR. MCKEEVER: Then again with the Chair's
25 permission I would like to provide the witness with

1 those pages from Dr. O'Hara's testimony which discuss
2 Priority Mail.

3 CHAIRMAN OMAS: Yes.

4 (Pause.)

5 BY MR. MCKEEVER:

6 Q Now, we've been through Dr. Geddes'
7 testimony on the market. As I mentioned, I'd like to
8 take a look at Dr. O'Hara's testimony now.

9 On page 21 at lines 19 to 23 Dr. O'Hara
10 testifies that while a 13.6 percent rate increase will
11 "have an adverse effect on Priority Mail users," and
12 I'm skipping now, "competitive alternatives are
13 obviously available to business users." Is that
14 correct?

15 A Yes, those phrases are in Dr. O'Hara's
16 testimony.

17 Q That's five lines, is that correct, in the
18 testimony?

19 A Three lines.

20 Q Three lines? Okay. I'll accept that.

21 A No. I'm sorry. Five. Through line 22.

22 Q And what Dr. O'Hara is saying there, I take
23 it, is don't worry too much about those business users
24 because they have alternatives available to them. Is
25 that correct?

1 A No, I don't believe that's what Dr. O'Hara
2 is saying.

3 Q You don't think that's what he means when he
4 says --

5 A I believe Dr. O'Hara's testimony is
6 indicating that he has considered the effect of a 13.6
7 percent rate increase on Priority Mail users,
8 including both business users and the general public,
9 and recognizes the fact that there would be an adverse
10 effect in terms of the impact of that increase.

11 I don't think it's a statement of don't
12 worry. I think it's a statement of genuine concern
13 for the effect of a large increase upon those
14 customers.

15 Q All right. I understand. But he does say
16 that while that increase will necessarily have an
17 adverse effect on Priority Mail, he goes, "but
18 competitive alternatives are obviously available to
19 business users." Is that correct?

20 A Yes, he does say that.

21 Q Okay. In fact, in the next sentence he
22 says, "and for the general public access to these
23 alternatives has become increasingly convenient in
24 recent years." Is that correct?

25 A Yes, he does.

1 Q I take it the "but" in that first sentence
2 indicates while the 13.6 percent increase will have an
3 adverse effect on users, they do have competitive
4 alternatives available to them though. I mean, how
5 else can you read that?

6 A I think Dr. O'Hara has pointed out a number
7 of factors associated with the Priority Mail and the
8 Priority Mail market and the impact of a 13.6 percent
9 increase and indicating a weighing of the potential
10 impact of an increase of that magnitude on customers
11 given the fact that alternatives are available.

12 Q Okay. Thank you. Could you turn to page
13 22?

14 A Of?

15 Q Of Dr. O'Hara's testimony. At lines 1 to 4
16 he refers to the impact of his proposal on
17 competitors. Is that correct?

18 A At lines 1 to 4 he refers to the effect on
19 private sector enterprises engaged in the delivery of
20 mail matter other than letters.

21 Q And that's competitors, right?

22 A Yes, I believe it would be.

23 Q Yes. He states at the end of the sentence
24 that the rate increase in his view is not unfair to
25 competitors. Is that correct?

1 A Yes, that is.

2 Q Okay. That's four lines. Is that correct?

3 A That paragraph is four lines.

4 Q Okay. On page 23 at lines 4 to 5 Dr. O'Hara
5 concludes in one sentence that his proposed rate level
6 is "fair and equitable to competitors." Is that
7 correct?

8 A At lines 4 to 5 he says, "The proposed rate
9 level is appropriate in light of all relevant
10 criteria. It is fair and equitable, Criterion 1, to
11 both mailers and competitors."

12 Q And competitors. Right. That's one or two
13 lines. Is that correct?

14 A That paragraph is two lines.

15 Q There aren't any other references to the
16 market context of Priority Mail in Dr. O'Hara's
17 testimony, are there?

18 A I would have to review all of Dr. O'Hara's
19 testimony. I believe he does discuss the effect on
20 competitors for --

21 Q We're talking about Priority Mail now.

22 A Yes. I'm not certain if he uses Priority
23 Mail as an example in his general discussion of that.

24 Q Okay. But at least when he is addressing
25 Priority Mail specifically he has about 10 or 11 lines

1 on the market. Is that correct?

2 A I haven't counted the number of lines.

3 Q That's the lines we just went through.

4 A I haven't counted the number of lines, but I
5 don't think a line or a word count represents a valid
6 measure of the consideration of the effect on
7 competitors or customers of a specific rate proposal.

8 Q But it does indicate the extent to which he
9 is providing a market context to inform the
10 Commission's decision in this case, doesn't it?

11 A I suppose in some sense counting the number
12 of the lines could indicate an extent of discussion,
13 but it does not necessarily reflect the degree of
14 consideration that goes into forming the proposal.

15 Q We only know what he says in his testimony
16 though, right?

17 A From my understanding of how the Postal
18 Service has developed rate proposals, there's serious
19 consideration given to all of the criteria, including
20 the effect on competitors and customers of all of the
21 proposed rate increases.

22 Q Well, we'll let a comparison of Dr. Geddes'
23 discussion of the market context with Dr. O'Hara's
24 stand where I guess we have it now, okay?

25 Let me go then to that part of your

1 testimony where you pointed out earlier and you stated
2 on page 16 at lines 7 to 9 that Dr. Geddes "fails to
3 provide the rate context for his proposal." That's
4 what you state there again, right?

5 A Yes. I state he fails to provide a market
6 and rate context for his proposal.

7 Q Yes, and we talked about the market context
8 just now.

9 A Yes. Those two are in conjunction, not
10 separate.

11 Q Okay. Let me see if I can help understand
12 what you meant there.

13 Let's take a look at page 17 of Dr. Geddes'
14 testimony. On line 1 Dr. Geddes expressly refers to
15 Priority Mail "rate increases of 2001 and 2002,"
16 doesn't he?

17 A Once again, that's the sentence where he's
18 paraphrasing Postal Service Witness Scherer who
19 identified several reasons, including the rate
20 increases of 2001 and 2002.

21 Q Yes, but Dr. Geddes puts in his testimony
22 the fact that there were Priority Mail rate increases
23 of 2001 and 2002, citing Postal Service Witness
24 Scherer. Is that correct?

25 A Yes, Witness Geddes cites Postal Service

1 Witness Scherer's discussion of the rate increases of
2 2001 and 2002.

3 Q And later on that same page, 17, he also
4 considers Priority Mail's volume history in light of a
5 number of events, including "its rate increases" on
6 line 10?

7 A The sentence is, "The recent volume
8 improvements indicate that whatever Priority Mail's
9 perceived service performance may be at a sufficiently
10 high value that its volume can recover from a series
11 of unfavorable events and rate increases."

12 That's a statement of what might happen in
13 the future.

14 Q Yes, but he's providing a context with
15 respect to the rate increases for Priority Mail. Is
16 that right? He's talking about Priority Mail rate
17 increases.

18 A One of the factors he's considering is the
19 effect of Priority Mail rate increases. Whether they
20 are the increases in the past or not is unclear.

21 Q Correct. In fact, at the bottom of that
22 page and the top of the next page he specifically
23 notes that, "The rate increases in R2000 and R2001-1
24 together increased Priority Mail rates by over 30
25 percent," doesn't he?

1 A Yes, that's his statement.

2 Q And he recognizes in the next sentence that
3 there was a 5.4 percent increase as a result of the
4 settlement in R2005-1?

5 A Yes, that's what it says.

6 Q All right. Let's compare that again with
7 Dr. O'Hara's testimony, if you still have that, on
8 Priority Mail.

9 In his two and a quarter or maybe two and a
10 half pages on Priority Mail Dr. O'Hara doesn't mention
11 even once Priority Mail's recent rate increases, does
12 he?

13 A Witness O'Hara's testimony discusses the
14 effect of the currently proposed rate increase upon
15 Priority Mail customers.

16 Q But that's the only one. He doesn't put
17 that in the context of any other increases that have
18 occurred. Is that correct?

19 A That's correct.

20 Q Okay. Now switching to a somewhat different
21 subject, let's go to page 17 of your testimony.

22 With respect to Dr. Geddes discussion of
23 Priority Mail's recent volume growth, at lines 10 and
24 11 you state, "Once again, context is lacking in his
25 analysis." Is that correct?

1 A Yes.

2 Q Dr. O'Hara doesn't mention Priority Mail's
3 recent volume growth even once in his testimony on
4 Priority Mail, does he?

5 A Dr. O'Hara does not discuss the growth in
6 Priority Mail over the last year or so. I believe
7 Witness Scherer may discuss that. I'm not certain.

8 Q Yes, but Dr. O'Hara is the one who comes up
9 with the cost coverage proposal. Is that correct?

10 A That is correct.

11 Q And he doesn't discuss Priority Mail's
12 recent volume growth even once in his testimony on
13 Priority Mail?

14 A He does not.

15 Q Okay. In your testimony you compare
16 Priority Mail's volume in fiscal year 2000 to its
17 volume in fiscal year 2005. Is that correct?

18 A That is correct.

19 Q Fiscal year 2000 was the historical high
20 point of Priority Mail's volume, wasn't it?

21 A I believe that's the case.

22 Q At no time was its volume ever that high.
23 Is that correct?

24 A I believe that's correct.

25 Q Now, instead of starting with fiscal year

1 2000 when Priority Mail's volume was at its high
2 watermark, Dr. Geddes in his testimony, if you can go
3 back to that, and I'll refer you to page 17.

4 Dr. Geddes includes in his testimony a table
5 showing Priority Mail's volumes for every year from
6 1990 through the third quarter of 2006. Is that
7 correct?

8 A Yes, Dr. Geddes includes a table of Priority
9 Mail volume history that is cited back to Witness
10 Scherer's testimony, which has also been included in
11 the Postal Service volume history library reference.

12 Q Yes. Dr. O'Hara didn't bother to mention
13 looking at that in his testimony. Is that correct?

14 A I don't believe Dr. O'Hara cites the volume
15 history, no.

16 Q Okay. Now, in many of those years prior to
17 2000 -- in fact, in most of them -- Priority Mail had
18 substantial volume growth, didn't it?

19 A For the years 1990 through 2000 there is a
20 positive volume growth in each year, yes.

21 Q In seven out of 10 of those years it had
22 double digit growth. Is that correct?

23 A That's my count.

24 Q And it was in 2001 when September 11 hit and
25 the economy slowed and the anthrax attacks occurred

1 that Priority Mail's volume started to decline until
2 2005. Is that correct?

3 A There is a decline beginning in 2001.
4 However, there is a number of effects that may have
5 caused that. You mentioned a few of them. We also
6 have the size of the rate increases in 2000 and 2001
7 as a factor that you did not mention.

8 I would note even though Witness O'Hara does
9 not cite to the volume history within his testimony,
10 that's general information that is available to form
11 his proposal.

12 Q We did establish earlier that Dr. Geddes
13 does refer to those rate increases in his testimony.
14 Is that correct?

15 A Dr. O'Hara cites Witness Scherer's
16 discussion of the rate increases of 2001 and 2002.

17 Q Pardon me. You meant Dr. Geddes? I think
18 you said Dr. O'Hara.

19 A Did I? I meant Dr. Geddes. I'm sorry.

20 Q Yes, because Dr. O'Hara doesn't, is that
21 correct, but Dr. Geddes does?

22 A Dr. O'Hara does not specifically discuss the
23 volume changes in 2001 and 2002. However, that forms
24 the context for the Postal Service's rate proposals.

25 Q Okay. Thank you. By the way, in early 1979

1 Priority Mail was I'll use the term redefined to
2 consist of pieces weighing more than 13 ounces whereas
3 before then it consisted of pieces weighing more than
4 11 ounces. Is that correct?

5 A No, that's not.

6 Q It's not correct?

7 A No. I believe you mean first class mail
8 breakpoint. The maximum weight of first class mail
9 was redefined on numerous occasions between roughly 11
10 and 13 ounces.

11 As far as I understand, customers have
12 always been able to send pieces weighing less than the
13 maximum first class mail by Priority Mail if they
14 choose to do so.

15 Q All right. I understand what you're saying.
16 Let's take it in your terms.

17 The first class mail breakpoint between
18 first class mail and Priority Mail was changed from 11
19 ounces to 13 ounces. Is that correct?

20 A That has happened on a couple of occasions,
21 as I recollect. I'm not quite sure of the dates.

22 MR. MCKEEVER: With the Chair's permission,
23 I'd like to show you a copy of your testimony, the
24 direct testimony of Maura Robinson on behalf of the
25 United States Postal Service, identified as USPS-T-34

1 in Docket R2000-1.

2 BY MR. MCKEEVER:

3 Q If you take a look at that testimony, I've
4 supplied the cover page and page 6 where under a
5 heading Volume Trends you discuss historical Priority
6 Mail volumes.

7 You indicate on lines 4 through 6, "However,
8 as of January 10, 1999, with the implementation of the
9 rates recommended and approved in Docket R97-1 the
10 maximum weight for first class mail increased from 11
11 ounces to 13 ounces." Is that correct?

12 A That is correct.

13 Q And then you state, "As a result,
14 approximately 12.4 percent of annual Priority Mail
15 volume is projected to migrate to first class mail."
16 Is that correct?

17 A Yes, it is.

18 Q So Priority Mail's volume declined at least
19 to some extent because pieces weighing from 11 to 13
20 ounces were classified as first class mail. Is that
21 correct?

22 A Just a couple of comments. The second
23 sentence at lines 6 through 8 that you cited says
24 approximately 12.4 percent is projected to migrate. I
25 believe that was a projection and may not have been

1 actual data. It's been too long.

2 Q I'm sorry? I just didn't hear you. It may
3 not what?

4 A I believe that is a projection and not
5 actual data. I'd have to go back and actually look at
6 how that rate design was done, but that is the
7 statement that is in the testimony.

8 Q Right. At least your expectation at that
9 time was that there would be a **12.4** percent decrease
10 in Priority Mail volume as a result of that
11 reclassification?

12 A That was my expectation, and it may have
13 been based upon Witness Musgrave in that case's
14 forecast.

15 Q Could you turn to page 18 of your testimony,
16 please? I'd like to clarify what you're saying at the
17 bottom of page **18** and the top of page 19 in
18 particular.

19 Let me start just with where you start. Dr.
20 O'Hara does propose a Priority Mail cost coverage of
21 163 percent in this case. Is that correct?

22 A I'm not seeing that here.

23 Q Well, you don't use Dr. O'Hara's name, but
24 you say it is that proposed by the Postal Service in
25 this docket, the 163 percent, on page 18, lines 19

1 through 22.

2 A The Postal Service's proposed cost coverage
3 for Priority Mail is 163 percent from Witness O'Hara's
4 Exhibit 31B.

5 Q Correct. Okay. Dr. O'Hara proposes that
6 cost coverage of 163 percent and notes that it
7 corresponds with a rate increase of 13.6 percent in
8 his testimony. Is that correct?

9 A That's correct.

10 Q Dr. O'Hara doesn't propose a rate increase
11 and then determine the cost coverage that corresponds
12 to that increase, does he? He recommends a cost
13 coverage and then says what the rate increases
14 resulting from that will be.

15 If you want to look at his testimony that I
16 provided you to refresh your recollection it is there.

17 A Dr. O'Hara justifies the Postal Service's
18 proposed rate increases and cost coverages based on
19 his assessment of the criteria. Those two go hand in
20 hand.

21 Q What two go hand in hand?

22 A Cost coverage and rate increase.

23 Q Yes. One implies the other.

24 A Yes, that's correct.

25 Q And Dr. O'Hara proposes a cost coverage,

1 which implies a rate increase, not vice versa,
2 correct?

3 A Dr. O'Hara is testifying that the cost
4 coverages proposed by the Postal Service meet the
5 criteria of the Act. That's the subject of his
6 testimony.

7 Q Yes, but let me try it again. I think the
8 question -- I'll try to make it more clear and more
9 simple.

10 Dr. O'Hara proposes a cost coverage **for**
11 Priority Mail of **163** percent and then notes that leads
12 to a **13.6** percent rate increase. He doesn't propose a
13 **13.6** percent rate increase and say that results in a
14 cost coverage of **163** percent. Is that correct?

15 A The two are not independent in that one of
16 the factors you must consider when proposing a cost
17 coverage is the size of the rate increase and the
18 effect on customers, competitors and all of the other
19 pricing criteria, so it's not a one causes the other.
20 It's a comprehensive look at what you're proposing for
21 the cost coverage for the class of mail.

22 It includes consideration of the size of the
23 rate increase and the impact of that rate increase.

24 Q Yes. He considers what the rate increase
25 implied by his cost coverage would be and takes it

1 into account, but it's a cost coverage he proposes,
2 isn't it?

3 A He is testifying in support of the cost
4 coverages. However, that involves consideration of
5 the size and effect of the rate increase.

6 Q I understand that. Let me ask you to go
7 back to Dr. O'Hara's testimony. Do you have that
8 still?

9 A Yes.

10 Q He says on page 21, the first couple lines,
11 "The Postal Service is proposing a cost coverage of
12 163 percent for Priority Mail. This corresponds to an
13 average rate increase of 13.6 percent."

14 Now, he takes into account that 163 percent
15 cost coverage means a 13.6 percent rate increase, but
16 it's the cost coverage he's proposing, not the rate
17 increase. Isn't that correct?

18 After he considers the effect of the rate
19 increase it's the cost coverage that he's proposing,
20 isn't it?

21 A I don't think they're independent. I think
22 they're inherently linked in that when you propose a
23 cost coverage that is associated with a given rate
24 increase. They're not one falls out from the other.
25 They are intrinsically linked.

1 Q Is it the rate increase that drives the
2 Postal Service's rate proposals normally?

3 A The Postal Service's rate proposals are
4 driven by the need to meet the revenue requirement
5 that in this case was presented by Witness Loutsch.

6 Q Well, the rates that the Postal Service
7 proposes for particular classes of mail, is that
8 driven by what rate increase it thinks is appropriate,
9 or is it driven by cost coverage, taking into account
10 the rate increase that the cost coverage implies?

11 A I think it's driven by a comprehensive look
12 at the circumstances, including cost coverage, of the
13 effect of a rate increase in the context of all of the
14 pricing criteria. It's not an either/or decision.

15 Q Well, I guess we've gone about as far as we
16 can go with this. Maybe I've spent too much time on
17 it, so I apologize.

18 Let's go back to your testimony on page 18
19 at lines 19 through 22 where you note that UPS Witness
20 Geddes suggests that the Commission recommend the cost
21 coverage for Priority Mail of 163 percent because, and
22 I'm focusing on the first part, it is close to that
23 recommended by the Commission in Docket R2001. Do you
24 see that?

25 A Yes, I do.

1 Q So you do recognize that Dr. Geddes'
2 recommendation of 163 percent is based at least in
3 part on the fact that that was the cost coverage
4 recommended by the Commission for Priority Mail in
5 R2000-1?

6 A That's my understanding of Witness Geddes'
7 testimony.

8 Q And that was in fact the cost coverage
9 recommended by the Commission for Priority Mail in
10 R2000-1, wasn't it?

11 A Approximately. I'm not sure of the specific
12 number. I don't have that with me.

13 Q Okay. And that 163 percent or approximately
14 163 percent, that was the cost coverage the Commission
15 adopted using the Commission's attributable costing
16 methods as the base. Is that correct?

17 A That's my understanding of the Commission's
18 decision.

19 Q Okay. Let's switch a little bit. I'll ask
20 you to take a look at Dr. O'Hara's testimony one more
21 time.

22 He testified on page 21 at lines 2 to 4 that
23 a rate increase, and I'm quoting here, "well above the
24 system average" is justified for Priority Mail because
25 "it reflects the above average growth of Priority

1 Mail's unit cost." Is that correct?

2 A The sentence states, "This," the Postal
3 Service's proposed rate increase I believe, "is well
4 above the system average, but reflects the above
5 average growth of Priority Mail's unit cost."

6 Q I think that's what I said, yes. Okay.
7 Thank you.

8 In your testimony on page 16 at lines 14 to
9 16 and in your Footnote 12 you testify that under the
10 Postal Service's proposal "Priority Mail rates will
11 have increased...59.3 percent in this decade." Is
12 that correct?

13 A Yes. "Assuming implementation of the Postal
14 Service's proposal, Priority Mail rates will have
15 increased 19.7 percent over 18 months and 59.3 percent
16 in this decade," and there's a footnote to the sources
17 for those computations.

18 Q Yes. Do you know or did you check to see
19 how much Priority Mail's unit attributable costs have
20 grown over that same time period?

21 A I generally understand those costs to have
22 grown. I don't know what percentage it was.

23 Q They've grown substantially, haven't they?

24 A I don't remember what the percentage is.

25 Q Would it surprise you if I told you that

1 Priority Mail's unit attributable costs have increased
2 by about 90 percent -- not 59 percent, but 90 percent
3 -- since docket R97-1?

4 A I've not done that calculation.

5 Q But we do know that its rates have increased
6 59 percent?

7 A Yes, we do.

8 MR. MCKEEVER: All right. That's all I
9 have, Mr. Chairman. Thank you.

10 CHAIRMAN OMAS: Thank you, Mr. McKeever.

11 Mr. Olson, Valpak Direct Marketing Systems,
12 Inc. and Valpak Dealers Association?

13 CROSS-EXAMINATION

14 BY MR. OLSON:

15 Q Good morning, Ms. Robinson. Bill Olson for
16 Valpak.

17 I want to ask you to begin with just your
18 autobiographical sketch, which doesn't indicate a long
19 cross-exam I don't think, but your autobiographical
20 sketch where you said you had a Bachelor's and a
21 Master's degree in Economics, correct?

22 A That's correct.

23 Q Do you consider yourself an economist?

24 A By training, yes.

25 Q By training. Let's look at page 1 of your

1 testimony, line 2, and this follows on what Mr.
2 Scanlon began with you where it says that your purpose
3 is to rebut the testimony of Kobe, Sidak, Panzar and
4 Mitchell in Footnote 1, correct?

5 A That's correct.

6 Q You say in the first sentence of your
7 testimony that witnesses for several Intervenors have
8 proposed prices or pricing approaches different from
9 those proposed by the Postal Service's direct case.

10 Could you easily categorize and summarize
11 for us the pricing approaches, plural, being proposed
12 let's say by Panzar, Sidak and Mitchell? Is there an
13 easy way to describe those for the Commission?

14 A I'm not sure there's an easy way to describe
15 them, but generally those witnesses suggest pricing
16 approaches that are typically referred to as efficient
17 component pricing.

18 Q So you're criticizing or rebutting the
19 testimony of Sidak, Panzar and Mitchell, which you
20 characterize as generally recommending efficient
21 component pricing?

22 A I believe their testimonies recommend
23 efficient component pricing. What my testimony is
24 rebutting is the presumption that that is the sole
25 pricing approach to be used within the context of the

1 pricing criteria. I'm looking at things in a somewhat
2 broader approach than their testimonies would suggest.

3 Q So your proposal, your suggestion, is that
4 efficient component pricing is too narrow of a basis
5 on which to make these decisions?

6 A I believe efficient component pricing
7 provides information upon which you can base decisions
8 in rate design. However, I don't think it's the only
9 factor or even necessarily a predominant factor given
10 the context of all of the pricing proposals

11 It's not the sole way one can construct
12 rates, and it may not be appropriate in all
13 circumstances.

14 Q Okay. Let's go to page 16 of your
15 testimony. That is with respect to Witness Geddes.
16 I'm sorry. Strike that. I'm sorry. It was line 16,
17 not page 16.

18 If you could go back to page 1, lines 16
19 through 18? You say, "No Intervenor has appropriately
20 balanced the economic efficiency goal which underlies
21 ECP with a full consideration of the context in which
22 the Postal rates are established."

23 Is that in essence what you've just said?

24 A That's what my testimony says, yes.

25 Q Can you explain the economic efficiency goal

1 that underlies ECP?

2 A Generally the efficient component pricing
3 theory suggests that discounts should be set exactly
4 equal to costs avoided, which allows a customer to
5 make a choice based on the Postal Service's cost of
6 whether they would perform an activity on their own
7 behalf such as presorting or not do that and have the
8 Postal Service perform that activity.

9 Q And that's what you characterize as the
10 pursuit of economic efficiency objectives?

11 A Yes, that's one way one can measure economic
12 efficiency.

13 Q All right. You cite in your testimony the
14 direct testimony of John Panzar for Pitney Bowes in
15 this docket a few places, correct?

16 A That's correct.

17 Q Do you have that testimony with you?

18 A No, I don't.

19 MR. OLSON: Mr. Chairman, if I may provide
20 the witness with a copy?

21 COMMISSIONER **ACTON**: Please do.

22 BY MR. OLSON:

23 Q What I've handed you is two pages from Dr.
24 Panzar's testimony in this docket, his direct
25 testimony for Pitney Bowes, Pitney Bowes-T-1, pages 47

1 and 50.

2 I want you to just look at his testimony at
3 line 11 there on page 47 where he says, "My analysis
4 focuses on pricing rules that promote the overall
5 productive efficiency of the Postal sector. However,
6 that is not necessarily equivalent to pricing rules
7 that maximize the economic efficiency of the Postal
8 sector."

9 Would you explain, if you could, your
10 understanding of the difference between productive
11 efficiency and economic efficiency?

12 A Productive efficiency generally involves the
13 production of a certain quantity of a good or service
14 using the most efficient combination of resources.

15 Economic efficiency can be a somewhat
16 broader concept. There's also things like allocative
17 efficiency, which involves how value, for lack of a
18 better word, is allocated between parties within an
19 economy.

20 Q And is that how you believe Dr. Panzar is
21 using those two terms in these lines of testimony on
22 page 47?

23 A I mean, I believe Dr. Panzar's testimony has
24 to speak for itself. He specifically defines how he's
25 talking about economic efficiency on lines 13 through

1 roughly 19 or 20.

2 Q Okay. First of all, you would agree that
3 productive efficiency and economic efficiencies are
4 two different concepts, correct?

5 A They're somewhat different concepts, but I
6 think you could include productive efficiency within
7 the overall context of economic efficiency in some
8 sense.

9 Q Let me ask you. Do you think it's important
10 to distinguish between which type of efficiency you're
11 trying to attain in your pricing approaches,
12 productive or economic, or they're both pretty
13 similar?

14 A I think you first need to step back and
15 realize that within the context of Postal pricing the
16 goal of economic efficiency is not the sole goal of
17 Postal pricing. The factors and the criteria in the
18 Act suggest a broad range of things other than
19 economic efficiency that should be considered.

20 Economic efficiency or efficiency in general
21 typically informs decisions about Postal Service
22 proposals and I understand the Commission's
23 recommended rates.

24 Q Let me tell you what's confusing me. It
25 goes back to my question a minute ago where I asked

1 about whether efficient component pricing was in aid
2 of or attempting to achieve economic efficiency, and
3 you agreed that that was what it was attempting to
4 achieve, correct?

5 A Generally, yes.

6 Q Okay. Well, if you turn the page there in
7 Witness Panzar's testimony he on lines 11 and 12 says,
8 "By promoting productive efficiency, the use of the
9 efficient component pricing rule for setting discounts
10 benefits both mailers and the Postal Service."

11 Is that inconsistent with your understanding
12 of what the goal of ECP is? You said it was in
13 pursuit of economic efficiency. He says it's in
14 pursuit of productive efficiency, and he distinguishes
15 them.

16 Is that a fundamental difference between you
17 and Dr. Panzar?

18 A I don't think it's a fundamental difference,
19 no.

20 Q But it is a difference?

21 A Yes, I think it is a difference. I mean, I
22 agree with his statement, "The use of efficient
23 component pricing does promote productive efficiency,"
24 but I think my point is that efficiency is not the
25 only criteria.

1 Q No, I understand that. I'm just trying to
2 deal with ECP and understand what type of efficiency
3 it's seeking to achieve.

4 Dr. Panzar said it seeks to achieve
5 productive efficiency. You said it seeks to achieve
6 economic efficiency. I'm just trying to rationalize
7 those two views. They seem quite different to me
8 because Dr. Panzar on page 47 clearly distinguishes
9 between productive and economic efficiency.

10 A I think I would agree that ECP is seeking to
11 promote productive efficiency, which is a component of
12 economic efficiency.

13 Q And would you agree that the notion that
14 productive efficiency is a subset of economic
15 efficiency is not reflected in Dr. Panzar's testimony
16 here on page 47?

17 A I'm not sure that's the case. I mean, he
18 states that economic efficiency is maximized with
19 prices so as to maximize the sum of economic profits
20 accruing to industry participants.

21 If you're attempting to maximize economic
22 profits, one would assume that the people producing
23 goods were also productively efficiently.

24 Q Did you have a chance to read the rebuttal
25 testimony of Advo Witness Crowder in this case?

1 A I believe I read portions of that.

2 Q At the beginning she says there are two just
3 different approaches. One is pursuit of economic
4 efficiency and one is pursuit of productive
5 efficiency. She picks which one she supports, and
6 it's very clear that she chooses between them and says
7 you have to go one way or the other.

8 You're saying that that's not necessarily
9 your understanding of those terms?

10 A I don't recollect that from Witness
11 Crowder's testimony. I have a difficult time reaching
12 a conclusion that one can be "economically efficient"
13 without productive efficiency as well.

14 Q When you use the term -- well, I think I'll
15 just leave it at that. Let me move on to pages 20 to
16 24 of your testimony where you discuss Witness
17 Mitchell's testimony.

18 Would you think it fair for me to
19 characterize an important part of Witness Mitchell's
20 testimony that he thinks that standard ECR coverages
21 as proposed by the Postal Service are too high and
22 standard regular coverages too low?

23 A I'll let Witness Mitchell's testimony speak
24 for itself, but that's my understanding of --

25 Q It's hard to come away from his testimony

1 and not have that fundamental understanding, correct?

2 A Correct.

3 Q Okay. Do you believe that it's possible for
4 a Postal expert to believe that the coverage being
5 proposed by the Postal Service for standard regular is
6 too low and the coverage for ECR is too high without
7 engaging in overemphasis of pursuit of the goals of
8 economic efficiency as you discuss it?

9 A I'm sorry. Could you repeat that?

10 Q Yes. You seem to criticize Witness Mitchell
11 for overemphasis of economic efficiency, correct?

12 A Uh-huh.

13 Q And in part it seems that that applies to
14 his selection of coverages for standard ECR and
15 standard regular, correct?

16 A Uh-huh.

17 Q So I'm just asking you is it possible that
18 an observer, a witness, an expert could come to the
19 view that the Postal Service's proposed coverages for
20 standard regular versus standard ECR were out of
21 balance and ECR was too high and standard regular was
22 too low for reasons other than economic efficiency?

23 In other words, is that the only reason you
24 think Mr. Mitchell is proposing a change in those two
25 coverages; that he's overly focused on economic

1 efficiency and that's his mistake?

2 A Witness Mitchell puts a considerable
3 emphasis on efficiency within his proposals. However,
4 the determination of what coverages are is not solely
5 driven by a goal of maximizing efficiency. There are
6 other policy considerations that go into those sorts
7 of discussions.

8 Q Would it be fair to characterize your
9 testimony as focusing on a rebuttal of what you
10 characterize as excess emphasis on economic
11 efficiency; that that's where you rebut him and not on
12 any other points as to why the coverage may be too
13 high in his view on ECR?

14 A No. I also think I discuss some issues
15 about the relative rate changes within ECR and a
16 number of other factors that have resulted in the
17 coverages that have been proposed by the Postal
18 Service and consideration of those factors as being
19 important in a way that Witness Mitchell does not
20 necessarily consider them.

21 Q Okay. So primarily effect on mailers? Is
22 that what you're saying?

23 A Well, not just effect on customers, but also
24 effect on the revenue requirement, the impact, what
25 customers should bear that burden. It's the effect on

1 the rate design that's actually discussed by Witness
2 Kiefer on rebuttal.

3 Q Okay. Let's go sequentially through those.
4 Let's stay on page 20 of your testimony for the moment
5 though. Let's go to lines 10 through 12.

6 There you say, "Valpak Witness Mitchell's
7 proposals highlight the danger of an overly narrow
8 focus on economic efficiency at the expense of
9 considerations of all other factors."

10 By economic efficiency you're referring to
11 what you understand his view to be to be overreliance
12 on efficient component pricing, correct?

13 A At the rate design level, yes.

14 Q Okay. Let's talk about rate design. Let's
15 think about setting cost coverages between subclasses.

16 A Uh-huh.

17 Q Would you give me your list of
18 considerations that you believe Witness Mitchell did
19 not give sufficient weight to? You mentioned effect
20 on mailers.

21 A Uh-huh.

22 Q The revenue requirement, the fact that
23 Witness Mitchell's rates would not get you to the
24 revenue requirement. Is that what you're saying?

25 A No. I believe Witness Mitchell did propose

1 a rate design that resulted in the same amount of mail
2 from the class standard mail, standard mail regular
3 and ECR.

4 However, I think there are considerable
5 concerns expressed particularly by Witness Kiefer on
6 how that process was done or what the results were,
7 the rates and rate relationships that resulted.

8 Q Okay. We'll get to Mr. Kiefer tomorrow, but
9 as for your testimony what are the other
10 considerations that you believe to be important that
11 Witness Mitchell did not give adequate attention to in
12 setting coverage between standard ECR and regular?

13 A Witness Mitchell has set up a coverage
14 proposal based on a presumption of an appropriate
15 relationship between ECR cost coverage and standard
16 mail regular cost coverages and is suggesting a fairly
17 dramatic reduction in ECR rates, a relatively low rate
18 increase and low cost coverage, that is difficult to
19 reconcile with the need to have reasonable rate
20 changes, reasonable price proposals associated with
21 that coverage.

22 Q So you're saying he didn't give enough
23 attention to the (B) (1) criterion of having fair and
24 reasonable rates?

25 A I think that's one consideration. He also

1 has not necessarily considered the context within ECR
2 and the fact that ECR has had generally lower than
3 normal rate increases -- lower than average I should
4 say rate increases -- over the last number of cases.

5 There are a number of factors that I would
6 consider in addition to what Witness Mitchell has
7 considered.

8 Q Anything else? I'm trying to get a list.
9 I'm trying to pin you down to know all the reasons
10 that you come up with that conclusion. You've given
11 several, and I just wonder if there are any others.

12 A I think fundamentally the proposal of a
13 substantial rate decrease for standard mail ECR in the
14 context of an overall rate increase poses some
15 questions of, as you mentioned, fairness and equity,
16 the effect on customers, both ECR customers and
17 standard mail regular customers, which is where
18 Witness Mitchell proposes to I'll say make up the
19 revenue.

20 It would also need to be considered in the
21 context of really all the pricing criteria. It's not
22 simply a fairness and equity. That's one of the
23 factors that needs to be considered, but there are a
24 number of others as well.

25 Q Have we identified them all?

1 A We've identified a number of them.

2 Q All that you can think of at this point?

3 A At this moment, yes.

4 Q Okay. Let's talk about rate design within
5 subclasses and I guess specifically within ECR and
6 within regular.

7 Do you have a list of considerations that
8 you believe to be important that you believe Witness
9 Mitchell did not address in that area?

10 A I believe Witness Mitchell's rate design is
11 the subject of Witness Kiefer's rebuttal testimony.

12 Q So you really don't address his rate design
13 within ECR or within regular? You simply are dealing
14 with the criticism of how he handles coverage between
15 subclasses?

16 A My testimony is primarily focused on the
17 cost coverage. However, if you cannot achieve
18 reasonable rates and rate relationships that is a
19 consideration.

20 I mean, you don't propose cost coverages
21 that cannot get you reasonable rates and rate
22 relationships.

23 Q I'm not sure what you just said. I'm sorry.
24 Does your testimony or does it not focus I think you
25 said on coverage, not on intersubclass rate design?

1 A That's correct.

2 Q If you could just turn the page and look at
3 page 21, lines 4 through 6? You have an interesting
4 sentence there I want to ask you about.

5 You say, "In other words, Witness Mitchell
6 believes that the Commission should return to a view
7 of standard mail pricing that may or may not have
8 existed in 1996."

9 Would you explain the difference between
10 returning to a view that may have existed and
11 returning to a view that may not have existed in 1996?

12 A Witness Mitchell's testimony discusses at
13 length the creation of the ECR subclass following
14 Docket No. MC95 with a suggestion that there was an
15 understanding that ECR markups would be adjusted
16 downwards over a period of time.

17 It's somewhat unclear to me that that has
18 ever been the Commission's stated view of what would
19 be happening to ECR cost coverage over time. The
20 Commission has typically analyzed the ECR cost
21 coverages and all of the cost coverages in light of
22 the criteria and reached the conclusion that the
23 recommended coverages were appropriate and consistent
24 with the Act.

25 As I said, Witness Mitchell appears to

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1 believe that there was a direction indicated by the
2 Commission of coverages being reduced, which seems to
3 be contradicted by the Commission's actual recommended
4 decisions that have typically resulted in coverages
5 that are somewhat higher than Witness Mitchell appears
6 to recommend.

7 Q Okay. So basically you're saying that he's
8 traced the history of relative coverages between
9 standard ECR and standard regular since the creation
10 of the separation of those two subclasses in MC95-1,
11 and you take a different view of the history than he
12 recites in his testimony along the lines you just
13 articulated?

14 A I think he accurately describes the changes
15 in the coverage over time. I believe that the
16 balancing that's inherent in the coverages recommended
17 in MC95 and the number of dockets following that is
18 not necessarily reflective with Witness Mitchell's
19 testimony.

20 Q In other words, you think that his
21 characterizations of what the Commission did are off
22 from your understanding?

23 A As I understand the Commission's recommended
24 decisions, they have balanced all of the criteria and
25 come up with the cost coverages that have been

1 recommended.

2 I mean, Witness Mitchell recognizes what
3 those cost coverages are. However, he seems to differ
4 in a belief that the coverages for ECR should be lower
5 and that the Commission's analysis has strongly
6 supported that.

7 Q Would you agree that he gives significant
8 attention in his testimony as to all the reasons that
9 he believes that the coverage for ECR is too high and
10 for regular is too low?

11 A He does discuss that at length.

12 Q And some of those go back to the foundation
13 of the classification of ECR, correct?

14 A Some of his reasons do go back to that
15 foundation, yes.

16 Q Okay. Let me ask you this. With respect to
17 the actual recommendations that he makes for coverages
18 and rates in this docket, are you taking the view that
19 he's basing them on anything other than let's say
20 current elasticities, current conditions, current
21 costs? I mean, aren't those rates based on those
22 current factors?

23 A My understanding of his testimony is they
24 are based on those current factors, as well as his
25 understanding of the history of the subclass.

1 Q Okay. Let's take a look at the next
2 sentence here, lines 8 through 12. You say that
3 Mitchell does not appreciate that theoretical
4 arguments about perfect cost coverage should be
5 tempered. I'm sorry. Should be or must be. Which
6 one do you want? You've got two of them.

7 A Sorry. Should be.

8 Q Should be. Okay. We'll take out "must be."
9 Should be tempered with a realistic assessment of how
10 changes in cost coverage affect not only the rates in
11 cost coverages recommended for standard mail ECR, but
12 also those recommended for other subclasses and the
13 revenue requirement of the Postal Service as a whole.

14 I think you indicated a minute ago -- more
15 than a minute ago -- that you understood that Witness
16 Mitchell's proposal to lower the coverage on standard
17 ECR was offset by a corresponding proposal to increase
18 coverage on standard regular, correct?

19 A That's my understanding.

20 Q Okay. Do you believe that changing the
21 relative contribution from standard regular and
22 standard ECR would cause rates for other subclasses to
23 change?

24 You used the words "other subclasses." Does
25 it affect periodicals?

1 A I don't believe Witness Mitchell is
2 proposing, for example, a change in periodicals cost
3 coverage or the cost coverage of a nonstandard mail
4 subclass.

5 However, the assessment of what cost
6 coverage you're going to propose for a specific
7 subclass within the context of an entire proposal
8 involves assessment across all of the subclasses, not
9 just a couple of subclasses.

10 Q So you're saying that the Postal Service has
11 viewed all the products, set the proper coverages, and
12 to come in and recommend changes relative between ECR
13 and regular can't be done because you have to look at
14 the whole, at every Postal product to change
15 coverages?

16 A I think you need to look at the total
17 picture to get an appropriate view of what coverages
18 should be, particularly when a proposal suggests
19 extremely large increases for a specific subclass or
20 corresponding decreases in the case of Witness
21 Mitchell's testimony for ECR.

22 I think he's looking at changes of a
23 magnitude that may not be appropriate, and given --

24 Q All I'm trying to get at is this other
25 subclass phrase.

1 First of all, you know that he didn't make
2 any other recommendations for other coverages other
3 than standard ECR and standard regular, correct?

4 A Correct.

5 Q Okay. So he didn't recommend any rate
6 changes outside of standard mail, correct?

7 A That's my understanding, yes.

8 Q Okay. So you're not criticizing him for
9 failure to consider or failure to have recommended
10 more than he did, for example?

11 You're not saying that you have to recommend
12 a whole new set of rates and coverages for every class
13 to be considered by the Commission and have your
14 arguments weighed. You're not saying that, are you?

15 A No. However, I believe what I'm trying to
16 state is that his coverages for standard mail regular
17 and ECR do not result in a proposal that appropriately
18 balances all the things one needs to do that.

19 We're looking at a case where we have a
20 proposal for ECR that's a substantial rate decrease in
21 the context of rate increases averaging I believe it's
22 8.5 percent for first class mail, periodicals, all the
23 other subclasses together, and that relative effect
24 needs to be considered.

25 Q so you really have to look at periodicals

1 rates, parcel rates, Priority Mail rates and coverages
2 in order to recommend a change relative between
3 standard regular and standard ECR? That's your
4 position?

5 A I think the results of a substantial rate
6 decrease for ECR does raise questions of fairness, how
7 you propose a cost coverage, what coverage you do
8 propose for that subclass as compared to the other
9 classes of mail that Witness Mitchell does not
10 discuss.

11 Q Well, I'm trying to understand your
12 criticism. Let's do it by looking at page 22,
13 Footnote 17.

14 There you say that Witness Mitchell does not
15 propose changes for any class of mail other than
16 standard mail, correct?

17 A Yes.

18 Q Okay. Is that a criticism of Witness
19 Mitchell's testimony?

20 A No. That's my understanding of Witness
21 Mitchell's testimony.

22 Q Okay. So it's not a criticism?

23 A The criticism of Witness Mitchell's
24 testimony is actually in the sentence that that
25 footnote is referred from, I suppose, and it's really

1 the question of why standard mail ECR should be given
2 a rate increase on the order of 8.5 percent.

3 A rate decrease -- excuse me -- on the order
4 of 8.5 percent as compared to all other subclasses.

5 Q I see. So what you're saying is that to
6 analyze fairness in rates you have to look at the
7 average price increase for each subclass and compare
8 them because it is in the relative relationships of
9 those average increases that you find fairness. Did I
10 get it?

11 A No. I think that's a bit narrow. One of
12 the things to consider in evaluating a rate proposal,
13 a coverage proposal of a rate increase proposal, is
14 how the relative burden of the institutional costs are
15 spread across the subclasses. One thing you would
16 consider is relative changes in rates as compared to
17 the need for the Postal Service to meet its revenue
18 requirement.

19 There are any number of other factors
20 specified in the Act that you would also consider.
21 For example, the XE value, effect on mailers, number
22 of available alternatives, et cetera.

23 Q Let me see if I can focus narrowly in my
24 question. You do know that Witness Mitchell has
25 proposed a comprehensive set of rates for all elements

1 within standard ECR and standard regular, correct?

2 A That's my understanding is proposed rates
3 for all the rate elements within those classes of
4 mail. At least that's my understanding.

5 Q It's not a short piece of testimony.

6 A No, it's not.

7 Q Okay. It probably took some people at the
8 Postal Service a while to get through it. In fact, do
9 you recall the last time that an intervenor has done
10 such a thing, proposing a complete alternative to the
11 Postal Service standard mail rates?

12 A I don't know if that's been done or not.

13 Q Do you know if any mailers -- I should have
14 asked this before perhaps, but do you know if any
15 mailer witness has ever come in and proposed a
16 complete new set of rates across all classes,
17 subclasses of mail as an alternative to the Postal
18 Service?

19 A I don't know if that's been done.

20 Q Okay. Well, if it's ever been done to make
21 a complete alternative proposal, and if it may never
22 have been done, to do a complete standard mail
23 proposal, is it a criticism of that proposal that it
24 is incomplete, that it doesn't address every single
25 postal product?

1 Only the Postal Service has done that. Only
2 the Postal Service has that perspective, and,
3 therefore, the Commission ought to defer to the Postal
4 Service, or would you concede that this is useful
5 testimony for the Commission to consider for standard
6 mail and should not be disqualified just because it
7 doesn't address every class and subclass?

8 A First, I don't know whether a comprehensive
9 proposal has been made by any witness.

10 Q Right.

11 A However, the context that the Commission has
12 to make its decisions does involve a comprehensive
13 look at all of the classes and all of the -- whatever
14 number of rates there are.

15 The focus of Witness Mitchell's testimony
16 solely upon standard mail raises questions as to
17 whether it is reasonable to propose rate decreases for
18 standard mail ECR in the context of the rate
19 proposals, the coverage proposals, for classes of mail
20 outside of standard mail.

21 Q You do understand the thrust of the question
22 that if you put the bar so high that a mailer, to come
23 up with an alternative to the Postal Service, has to
24 address everything, that no one could do it, and the
25 Commission is going to have to adopt Postal Service

1 rates in every case. That's not where you're putting
2 the bar, is it?

3 A My standard is not than an intervenor would
4 have to address everything but that they have to have
5 a reasonable proposal in the full context of the
6 Postal Service's rates, and a proposal that suggests a
7 substantial decrease of ECR rates in the context of an
8 increase in the revenue requirement and rate increases
9 for every other subclass of mail raises some
10 fundamental questions.

11 Q You call some of those fundamental questions
12 "preferential price treatment." Correct? If you go
13 to page 22, line 16?

14 A I think if standard mail ECR is given an
15 eight-and-a-half-percent decrease, on average, that
16 does suggest some preferential price treatment for
17 that subclass, as compared to other subclasses of
18 mail.

19 Q And you're implying, I take it, by
20 "preferential" that it is unjustified, unreasonable,
21 perhaps contrary to the act.

22 A I think the word "preferential" suggests
23 that it is a lower increase than for other classes of
24 mail, and my testimony in general discusses why I
25 don't believe that is appropriate and consistent with

1 the criteria of the act.

2 Q And when you say "preferential price
3 treatment," are you talking about the reduction in
4 coverage or the reduction in rates or both for ECR?

5 A Once again, coverage and rates are not
6 mutually exclusive. They are tied together.

7 Q I understand that. I remember your
8 discussion with Mr. McKeever.

9 When you use the term "preferential price
10 treatment" as a criticism of Witness Mitchell's
11 proposal in your rebuttal testimony to him, are you
12 referring to his proposal for a lower ECR cost
13 coverage or for a lower average rate increase for ECR
14 or both? If it's both, that's fine.

15 A I believe, in the sentence, it's referring
16 to the reduction in the ECR average rates, just in
17 this context.

18 Q So whether in this sentence or not, would
19 you criticize Witness Mitchell's proposed reduction in
20 the ECR coverage as preferential price treatment?

21 A I think, given the result of his cost
22 coverage proposal, is a rate decrease in the full
23 context of the rate proposal? Yes. That's
24 problematic. There are issues that need to be
25 considered there.

1 Q Let me ask you general, then, if the
2 Commission agreed with an Intervenor's argument that
3 the cost coverage for a particular product was too
4 high and should be reduced, is it your view, then,
5 that the Commission would be giving reduced below what
6 the Postal Service is requesting, then the Commission
7 is giving preferential price treatment to that
8 subclass or product?

9 A I believe the Commission makes
10 recommendations based on an interpretation of the
11 statutory pricing criteria, that their recommended
12 decisions are consistent with that. A question of
13 whether a proposal resulting in a reduction in cost
14 coverage compared to some other number is appropriate
15 or inappropriate depends on the context within which
16 that proposal is made.

17 Q Let's assume, just for purposes of this
18 question, that you have cost coverage that is out of
19 whack, too high. Wouldn't you agree that, by your
20 analysis categorizing these as preferential price
21 treatment, that no such too-high coverage could ever
22 be remedied by the Commission? If it fixed the
23 coverage, it would be preferential. It would be
24 preferential price treatment. Isn't that what you're
25 saying?

1 A No. That's not what I'm saying. What I'm
2 suggesting is that Witness Mitchell's proposal in this
3 case is such that it raises fundamental questions as
4 to whether ECR is receiving preferential treatment.
5 That's not to suggest that every circumstance where
6 coverage would be reduced is inappropriate.

7 Q My question was a hypothetical. It wasn't
8 narrowly restricted to Witness Mitchell. I'm just
9 saying, if any mailer were to believe that the
10 coverage on the products they presumably use are way
11 too high, come in and make an argument that it's way
12 too high, you would say to the Commission, "Don't fix
13 it. It's preferential price treatment." That would
14 be one of your arguments.

15 A I think you would need to evaluate any
16 hypothetical proposal such as that within the context
17 of not only that subclass but the entire analysis of
18 cost coverages across all of the subclasses. You
19 can't say, in absolute terms, that there are not
20 circumstances where a reduction in cost coverage may
21 be appropriate. I don't believe that the reduction
22 proposed by Witness Miller in this case is
23 appropriate.

24 Q Mitchell?

25 A Mitchell, yes. I'm sorry.

1 Q I thought that's what you meant.

2 Is there an opposite of a preferential price
3 treatment? In other words, if you have a coverage
4 that's too high, and it lasts for a very long time, is
5 that a detrimental price treatment that ought to be
6 prohibited under the act?

7 A The rates and fees recommended by the
8 Commission have been found to be consistent with the
9 act.

10 Q I'm just asking you, if one is too high, and
11 it goes on for a while, is that a detrimental price
12 treatment that ought to be cured?

13 A The proposals that the Postal Service has
14 made in this case involve a balancing of what the
15 appropriate coverage for the various subclasses should
16 be. That balancing involves an assessment of the
17 costs, the various factors within the pricing
18 criteria. It's not a static snapshot of a
19 circumstance at a particular point in time. It's a
20 proposal for rates going forward.

21 Q Okay. Let's talk about legislation. You
22 have, in your testimony, page 22, a discussion of
23 Witness Mitchell's alternative set of cost coverages
24 in the event that Congress does not enact legislative
25 changes in postal reform legislation. You say, in

1 line 8, you say that "either the Commission sets rates
2 based on things the way they are today, or the
3 Commission could speculate and prejudge how it might
4 implement a yet-to-be-enacted legislative proposal."
5 Do you see that?

6 A Uh-huh.

7 Q Okay. I take it, if you use words like
8 "speculate" and "prejudge," that that's a negative,
9 and you would think that shouldn't be done. Correct?

10 A I believe the Commission's obligation is to
11 recommend rates that are consistent with the current
12 statute and that rates were recommended based on some
13 projection of how a statute might change would not be
14 appropriate.

15 Q Okay. Let me see if you understand what
16 Witness Mitchell said, as I understand it, or if you
17 have a completely different view. Do you understand
18 that Witness Mitchell set forth to the Commission a
19 set of recommended coverages for standard ECR and
20 standard regular which are at odds with what the
21 Postal Service has proposed and that those relative
22 rate relationships, if there were only one more rate
23 case, he says, we ought to move toward the optimal
24 adjustment, whatever the Commission feels that is --
25 he has his opinion, and you have yours -- we ought to

1 move to that now. Do you understand that that's one
2 of the things he says in his testimony?

3 A As I understand it, Witness Mitchell's cost
4 coverages and the rates he proposes based on those
5 cost coverages are based on a judgment that there
6 should be movement towards what he views as being
7 appropriate cost coverages and rates and that if
8 legislative change would not be enacted, he would
9 suggest some smaller movement towards some set of
10 optimal rates.

11 Q But do you know why he suggested, then,
12 moving in phases?

13 A I believe it was a view of a more gradual
14 movement as opposed to a larger movement as being
15 appropriate.

16 Q And do you recall why he said that gradual
17 movement would be possible if there was no postal
18 reform legislation passed in this Congress?

19 A I don't recall at the moment.

20 Q I mean, you're familiar with postal
21 legislation. You were detailed up to Senator Collins,
22 weren't you, to advise?

23 A That's correct.

24 Q The Postal Service paid you to work for a
25 time for Senator Collins's office as an adviser.

1 A I was on detail to the Senate Governmental
2 Affairs Committee; however, I was not representing the
3 Postal Service's position at that time.

4 Q Is that the way details work?

5 A My understanding of that detail and my
6 direct instructions from the Postal Service was that I
7 was not representing the Postal Service's position,
8 that I was not to characterize anything as the Postal
9 Service's position, and that I was free to provide
10 advice based on my own views.

11 Q I appreciate that. That's interesting. It
12 doesn't go to what I was asking about initially, but I
13 did ask that question.

14 When you were up there, you read the bills
15 that were pending, you probably consulted with the
16 staff and the senators and explained this to them as
17 to how it would work. You do understand there is a
18 price cap in at least some of the legislation.
19 Correct?

20 A Price caps are in at least the Senate bill
21 and, to some extent, in the House bill, yes.

22 Q And that there has been discussion as to
23 whether there would be another rate case, if permitted
24 by Congress, that it's possible that they would move
25 toward a rate cap quickly, or they would give the

1 Postal Service another chance to file another rate
2 case. Isn't that true; there's two different
3 approaches?

4 A As I recall, the current legislation
5 generally allows for continued rate-making under the
6 current Title 39 until a new rate-making structure is
7 established.

8 Q Basically, there is the possibility, is
9 there not, that if postal reform were to pass, let's
10 say, next week, that it could have one of two
11 provisions in it, at least with respect to its
12 effective date? It could either be effective whenever
13 the general counsel's office here can write the
14 regulations and get them published and get comment and
15 implement the regulations for the new regime, or,
16 alternatively, it might say, as I believe the Postal
17 Service has urged, that it be allowed to have at least
18 one more rate case under the current system. Is that
19 at all familiar to you?

20 A Those are two possibilities. However, I
21 would also suggest that there are probably an infinite
22 number of other possibilities to put in the bills.

23 Q Exactly, exactly, and the point is, if the
24 bill is passed -- when testimony was submitted by
25 Witness Mitchell, did we know less or more than we

1 know today about what Congress is doing on the bill?

2 A I'm not sure I know the answer to that
3 question.

4 Q All right. Let me put it this way.

5 A We have a few more weeks of experience.
6 However, I don't know if we know more or less about
7 what will come out of the process.

8 Q Fair enough. Let me ask you this. If we
9 get to another week, and the Congress passes a
10 continuing resolution and goes home, and it's the end
11 of the Congress, we will know that postal reform will
12 have to come back next year if it's to come back at
13 all. Correct?

14 A If Congress adjourns without passing a bill,
15 my understanding is it would need to be reintroduced,
16 yes.

17 Q Okay. On the other hand, if a bill is
18 passed, the Commission would have the benefit of
19 knowing what that bill said when it issues its opinion
20 and recommended decision. Correct?

21 A Presumably, the Commission would know
22 whatever exists in statute at the time it issues its
23 recommended decision. The fundamental fact is, as we
24 sit right now, we are looking at Title 39 as it is
25 currently written, and the Postal Service's proposals

1 and the Commission's decisions need to be based on the
2 statute as it is currently written unless something
3 does happen, which is somewhat unclear as to whether
4 it will.

5 Q Exactly. Isn't all Witness Mitchell
6 saying -- isn't this all he said in his testimony,
7 that if the Commission only has once chance to get it
8 right before price caps come in, and it becomes very
9 hard to change any type of relative coverages, fix it
10 now? And, on the other hand, if the law is passed,
11 for example, and it allows another rate case, move to
12 it in two steps instead of one. That's not
13 complicated, is it? And that doesn't involve
14 speculation or -- I forget what your other words were.
15 Isn't that a reasonable position to take?

16 A Witness Mitchell's testimony presents the
17 rates that he believes the Commission should recommend
18 if legislative change is enacted. He does not propose
19 a rate structure, as I understand it, that represents
20 the current statutory rate-making regime. I believe
21 you've got to assess the rates and rate relationships
22 within the context of the current statute.

23 Q In what respect is Witness Mitchell's
24 proposal not based on the current statute, current
25 rules, current regime? In what sense is it not based

1 on those?

2 A I believe he states that if legislative
3 change is not enacted, he would suggest that the
4 Commission recommend coverages that are lower than the
5 coverages that are implied by his rate design that he
6 presents, and that, to me --

7 Q Repeat that. I'm sorry. I didn't catch it.
8 I didn't understand it.

9 A I believe his proposal -- the rates that he
10 derives and the associated coverages are what he
11 suggests would be appropriate if there were
12 legislative change.

13 Q Your reading of Witness Mitchell's testimony
14 is that his proposed adjustment to standard ECR and
15 standard regular, where standard ECR would go down,
16 and regular would go up, that that is a conditional
17 recommendation upon the passage of legislation.
18 That's the way you read his testimony?

19 A My understanding is that if legislation did
20 not pass, he would recommend that those rate changes
21 be mitigated in some sense, yes, the two-step proposal
22 on your coverage.

23 Q But the two-step proposal -- I will end with
24 this. But the two-step proposal is if the Commission
25 knows that it's going to have two opportunities to get

1 from here to wherever it wants to go, that it could
2 take some of it now and some of it in the next case,
3 and that's what Mitchell says, is it not? He says,
4 Otherwise, if you find out that the law changes, and
5 it says there are no more rate cases. We're under
6 price caps. We can't change relative coverages in
7 anything other than this docket. Do it now.

8 Isn't that clear? Isn't that what he is
9 saying in his testimony?

10 A I think that that is my understanding of his
11 testimony. However, I would suggest that what the
12 results of what he is proposing are not reasonable in
13 the full context of this rate proposal, this rate
14 proceeding.

15 Q That, I understand. I understand you think
16 his standard ECR coverage is too low, and standard
17 regular is too high. All I'm talking about is I just
18 want you to recognize with me that he is not asking
19 the Commission to speculate, prejudge, anything else.
20 He is asking the Commission to respond the way that
21 I'm sure you would recommend that it does, that it
22 would have a reasoned judgment as to what the
23 regulatory climate is going to be and what its
24 flexibility will be and act accordingly. There is one
25 case. If there's two cases, there's two cases. If

1 there's one case left, then there's one case.

2 A I think you need to consider the rates and
3 rate proposals in the context of the current statute
4 and the current pricing criteria that have been set
5 forward. Witness Mitchell is proposing a somewhat
6 more modest change in ECR rates and standard mail
7 regular rates in opposite directions if that current
8 proposal does not change. However, the rates he
9 derives --

10 Q But if it doesn't change, or if it does
11 change?

12 A If the legislation is not enacted.

13 Q He proposes a more modest change if the
14 legislation is not enacted. That's your
15 understanding?

16 A My understanding is he proposes a more
17 gradual movement towards what he has described as the
18 appropriate end point for cost coverages for those two
19 subclasses.

20 MR. OLSON: We'll leave Witness Mitchell's
21 testimony to speak for itself, and I thank you so much
22 for your assistance. Thank you, Mr. Chairman.

23 CHAIRMAN OMAS: Thank you, Mr. Olson.

24 Is there anyone else who wishes to cross-
25 examine Witness Robinson?

1 MR. McKEEVER: Mr. Chairman, just three or
2 four clarifying questions on efficient component
3 pricing to follow up.

4 CHAIRMAN OMAS: Mr. McKeever.

5 MR. McKEEVER: Thank you.

6 CROSS-EXAMINATION

7 BY MR. McKEEVER:

8 Q Ms. Robinson, is economic efficiency the
9 only consideration that is relevant to efficient
10 component pricing or that underlies efficient
11 component pricing?

12 A It's a primary consideration, as I
13 understand it, yes.

14 Q Okay. How about fairness? Does that come
15 into play here, too?

16 A I view fairness as being a much broader
17 concept than simply the application of efficient
18 component pricing.

19 Q But is it relevant to the adoption of
20 efficient component pricing or not?

21 A I think you could appropriately judge rates
22 resulting from efficient component pricing based on
23 fairness criteria, yes.

24 Q Okay. Do you think it's fair to give a
25 customer a discount of, say, \$11 when that customer

1 saves the Postal Service only \$10?

2 A I think you would need to carefully evaluate
3 the total set of circumstances surrounding that
4 situation, that proposal.

5 Q So that may or may not be fair.

6 A You would need to look at the specific case.
7 There is no way to answer that question in the
8 abstract.

9 Q And that's your answer, even if some other
10 customer has to make up that dollar loss in revenue
11 resulting from a discount that is greater than the
12 cost saved?

13 A I think you need to look at it in the full
14 context within which that rate is proposed, yes.

15 MR. McKEEVER: Thank you, Mr. Chairman.

16 CHAIRMAN OMAS: Thank you, Mr. McKeever. Is
17 there anyone else? Commissioner Goldway.

18 COMMISSIONER **GOLDWAY**: I have some general
19 questions for you. I know that your position with the
20 Postal Service involves the overall planning for
21 rates, and you've also been involved in long-term
22 strategy with regard to rates.

23 In your testimony, your rebuttal testimony,
24 you're concerned about the proposals that would
25 decrease the first-class stamp, and, in doing that,

1 you point out that single-piece, first-class postage
2 accounts for \$15.9 billion, or 22.8 percent, of Postal
3 Service revenue. That means that first-class, single-
4 piece revenue counts for a much greater share of
5 first-class revenue than the rest of first-class
6 revenue, is the way I figure it as well.

7 Basically, single-piece, first-class mail,
8 letter subclass revenue is about \$19 billion.
9 Presorted first-class mail letters is about \$16
10 billion.

11 So presorted is roughly equivalent in
12 dollars to --

13 THE WITNESS: It's about \$3 billion lower,
14 and this is test year after rates.

15 COMMISSIONER GOLDWAY: Given that first-
16 class mail, in particular, single piece, is a
17 declining volume, and all predictions are that it will
18 continue to decline, isn't it kind of a risky business
19 strategy to count on first-class mail for all that
20 revenue?

21 When you're considering these rates, what
22 kind of consideration have you given to the notion of
23 increasing cost coverage on standard mail, which is,
24 in fact, a growing volume? I think we have not had a
25 discussion of the kind of strategic implications of

1 the rate patterns that we've been operating under for
2 30 years and that, in fact, you're exaggerating in
3 this particular rate case by delinking single piece
4 and presorted mail.

5 What kind of thought did you give to the
6 notion that it may not be in the long-term interests
7 of the Postal Service to rely on first-class revenue
8 for the cost coverage and the operational revenue
9 needed to run the entire Postal Service?

10 THE WITNESS: First, I would note that the
11 revenues estimated for the test year after rates do
12 include the projected impact of changes in first-class
13 mail volumes and standard mail volumes. Those are
14 included in the financial analysis that underlies the
15 rate proposals in this case.

16 The Postal Service is obviously very
17 concerned about trends in first-class mail volume over
18 time. What we are looking at is, given our
19 projections for the test year after rates, what's the
20 most reasonable rate proposal that both meets the
21 revenue requirement and meets the other criteria of
22 the act?

23 As you'll notice, first-class mail does get
24 a somewhat lower rate increase under our proposal than
25 standard mail does, and that's based on the full

1 assessment of those criteria, as discussed by Dr.
2 O'Hara.

3 COMMISSIONER GOLDWAY: Can you give me the
4 estimates of the percentages of what the rate increase
5 is for first-class versus standard?

6 THE WITNESS: First-class letters and sealed
7 parcels are proposed to get a 7.1 percent rate
8 increase. Standard mail, regular, is proposed to have
9 a 9.6 percent rate increase; and standard mail,
10 enhanced carrier route, is an 8.9 percent rate
11 increase under the Postal Service's proposal.

12 COMMISSIONER GOLDWAY: **And** within first
13 class, is there a difference between single piece and
14 presort?

15 THE WITNESS: From Witness Taufique's
16 testimony at page 3, single-piece letters are proposed
17 to have a 7.7 percent rate increase, and presorted
18 letters are proposed to have a 6.4 percent rate
19 increase.

20 COMMISSIONER GOLDWAY: So with the delinking
21 proposal, you've put somewhat more of a burden on
22 single-piece letters than on presorted letters.

23 THE WITNESS: Witness Taufique's proposal
24 ties single-piece, first-class mail letters and
25 presorted letters through the average contribution per

1 piece. You need to be a little bit careful in that
2 the mail characteristics of single-piece letters and
3 presorted letters are substantially different.
4 There's many more additional ounces in single-piece
5 letters, which tends to push contribution up for those
6 letters.

7 COMMISSIONER GOLDWAY: But I would bet a
8 whole lot of single-piece mail is courtesy-reply-
9 envelope mail, which is real cheap.

10 THE WITNESS: Yes. A substantial portion
11 is, yes.

12 COMMISSIONER GOLDWAY: When you were doing
13 these figures, did you do any work on what the effect
14 on elasticity would be if you were to raise standard
15 rates more than your current proposal?

16 THE WITNESS: As I understand elasticities,
17 they measure the change in volume based on a given
18 price change, so elasticities give you the ability to
19 measure the volume change. They are estimated at a
20 specific point on the demand curve, and beyond that, I
21 think I would let Witness Thress discuss that.

22 COMMISSIONER GOLDWAY: Have you read Witness
23 Sidak's testimony?

24 THE WITNESS: Yes, I have.

25 COMMISSIONER GOLDWAY: He makes a fairly

1 good case that the elasticity for advertising mail,
2 standard mail, may be less than what we consider in
3 relationship to first-class mail. Have you thought of
4 that at all when you were looking at your strategy for
5 future price formulations for first class versus
6 standard, that, in fact, there seems to be a stronger
7 demand, market demand, for advertising mail than there
8 is for first-class mail, and perhaps it could, in
9 fact, absorb a greater price increase?

10 THE WITNESS: I believe that would be
11 incorporated in the elasticity estimates that Witness
12 Thress has made.

13 COMMISSIONER GOLDWAY: But I'm not sure they
14 do, and I'm wondering whether, in strategizing for the
15 future, whether you've thought about reevaluating what
16 standard mail looks like in light of Witness Sidak's
17 testimony.

18 THE WITNESS: The Postal Service, in
19 constructing its proposal, does assess the entire
20 environment in which it finds itself. I'm not
21 certain, based on Witness Sidak's testimony filed just
22 a few days ago, that the discussion of the specific
23 implications of his testimony on possible future rate
24 proposals has occurred. However, the issues you're
25 talking about are very clearly considered as the

1 Postal Service works through business strategy
2 associated with the pricing of its various classes of
3 mail.

4 COMMISSIONER **GOLDWAY**: I'm glad to hear that
5 because I really do think that, regardless of the
6 decisions in this case, there are much larger
7 strategic decisions that will have to be made in the
8 future about how to price these products and how to
9 offer premium services that people are willing to pay
10 for the increased revenue.

11 The one other question I had was with regard
12 to the forever stamp. I know it's a commitment that
13 the Postal Service has made, although the specific
14 implementation is still a little vague, but is it
15 possible that one could think that in the future, with
16 more use of the forever stamp, that it also would, in
17 fact, result in somewhat lower cost coverages for
18 single-piece, first-class mail because people would
19 have the benefit of using that forever stamp in the
20 next rate case and, therefore, would be paying
21 somewhat less?

22 THE WITNESS: That actually raises some
23 interesting questions on how you account for purchases
24 of the forever stamp that are used for some later
25 date. The cost coverages proposed across the various

1 subclasses will depend on the revenue requirement and
2 the assessment of the various pricing criteria, and I
3 would think the availability of the forever stamp
4 would be considered in that assessment.

5 COMMISSIONER GOLDWAY: Okay. Well, I think
6 that's an interesting thought to work on once we've
7 had some experience with the first-class stamp. Of
8 course, you'll get the flow, which may provide some
9 additional revenue, too.

10 THE WITNESS: And there is also some concern
11 about a downside risk for people retaining the flow
12 periods of time.

13 COMMISSIONER GOLDWAY: Okay. Thank you for
14 your testimony. I appreciate it.

15 CHAIRMAN OMAS: Is there anyone else who
16 would like to? Mr. Harwood.

17 CROSS-EXAMINATION

18 BY MR. HARWOOD:

19 Q I have just one brief follow-up on something
20 you answered to Commissioner Goldway when you talked
21 about the effect of the changes in first-class mail
22 being reflected in the test year after rates here. Is
23 that the effect that is shown in Dr. Thress's study
24 that was presented with his direct case?

25 A The volume effects that underlie the revenue

1 projections that Dr. O'Hara's cost coverages resulted
2 in are based on the elasticity estimates that Witness
3 Thress presented in his direct case, yes, his direct
4 testimony.

5 Q And his elasticities are what you and the
6 Postal Service are relying on for you conclusions as
7 to the effect on test year after rates. Is that
8 right?

9 A Yes. That's how the price changes are
10 incorporated into the volume forecast.

11 MR. HARWOOD: Thank you.

12 CHAIRMAN OMAS: Thank you, Mr. Harwood.

13 Is there anyone else?

14 (No response.)

15 CHAIRMAN OMAS: There being none, Mr.
16 Tidwell, would you like some time with your witness?

17 MR. TIDWELL: Yes, Mr. Chairman. Could we
18 reconvene on the hour?

19 CHAIRMAN OMAS: Yes. Why don't we do that?
20 We'll come back at 1 o'clock. Thank you.

21 (Whereupon, a short recess was taken.)

22 CHAIRMAN OMAS: Mr. Tidwell?

23 MR. TIDWELL: Mr. Chairman, the Postal
24 Service has no redirect.

25 CHAIRMAN OMAS: Thank you.

1 Ms. Robinson, there being no redirect, that
2 completes your testimony here today. We appreciate it
3 and your contribution to our record, and you are now
4 excused. Thank you.

5 (Witness excused.)

6 CHAIRMAN OMAS: I think we will now take a
7 lunch break and come back at 1 o'clock.

8 (Whereupon, at 12:04 p.m., a luncheon recess
9 was taken.)

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(1:09 p.m.)

MR. BAKER: Thank you, Mr. Chairman. The Newspaper Association of America calls J. Gregory Sidak to the stand.

MR. SIDAK: I have not.

Whereupon,

having been duly sworn, was called as a
 and was examined and testified as follows:

DIRECT EXAMINATION

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1 Q And I ask the witness to verify that -- is
2 under your supervision.

3 A Yes, it is.

4 Q And you've adopted it as your testimony in
5 this proceeding.

6 A Yes, I do.

7 CHAIRMAN OMAS: Mr. Baker, can you speak a
8 little louder and check to make sure that your
9 microphone is on?

10 MR. BAKER: Very well, Mr. Chairman. I move
11 to (off mike.)

12 CHAIRMAN OMAS: Is there any objection?

13 (No response.)

14 CHAIRMAN OMAS: Hearing none, I will direct
15 counsel to provide the reporter with two copies of the
16 corrected testimony of J. Gregory Sidak. That
17 testimony is received into evidence and is to be
18 transcribed into the record.

19 (The document referred to was
20 previously marked for
21 identification as Exhibit No.
22 NAA-RT-1 and was received in
23 evidence.)

24 //

25 //

NAA-RT-1

FINAL (Nov. 28,2006)

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2006

Docket No. R2006-1

REBUTTAL TESTIMONY OF J. GREGORY SIDAK
ON BEHALF OF
THE NEWSPAPER ASSOCIATION OF AMERICA

Date: November 20,2006

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INTRODUCTION AND QUALIFICATIONS

My name is J. Gregory Sidak. My business addresses are 6018 Hotung International Law Building, Georgetown University Law Center, 600 New Jersey Avenue, N.W., Washington, D.C. 20001, and Criterion Economics, LLC, 1620 Eye St., N.W., Suite 800, Washington, D.C., 20006. My qualifications and background regarding postal regulation and efficient component pricing are presented in my direct testimony in this proceeding.

In addition to those qualifications, I am also an expert on telecommunications, broadband communications, and the Internet. I was Deputy General Counsel of the Federal Communications Commission from 1987 to 1989. From 1992 through 2005, I was a resident scholar at the American Enterprise Institute for Public Policy Research (AEI), where I directed AEI's Studies in Telecommunications Deregulation and held the F.K. Weyerhaeuser Chair in Law and Economics. From 1993 to 1999, I was a Senior Lecturer at the Yale School of Management, where I taught a course on telecommunications regulation with Dean Paul W. MacAvoy.

I have been a consultant to more than 20 companies in the telecommunications, media, and computing industries in North America, Europe, Asia, and Australia. I have also been a consultant to the Republic of Mexico in the World Trade Organization dispute between the United States and Mexico concerning international telecommunication services. For four years, I have been a member of the U.S. Advisory Board of NTT DoCoMo, Japan's largest wireless telecommunications company. In that capacity, I have met twice annually with the

O' CEO and senior management of DoCoMo to discuss strategic business, technology,
2 and regulatory matters concerning telecommunications services.

3 I have written numerous books on telecommunications. With Dan Maldoom,
4 Richard Marsden, and Hal J. Singer, I am the co-author of ***Broadband in Europe:
5 How Brussels Can Wire the Information Society*** (Springer 2005). I am the author of
6 ***Foreign Investment in American Telecommunications*** (University of Chicago Press
7 1997). With Daniel F. Spulber, I am the co-author of ***Deregulatory Takings and the
8 Regulatory Contract: The Competitive Transformation of Network Industries in the
9 United States*** (Cambridge University Press 1997). With William J. Baumol, I am the
10 co-author of ***Toward Competition in Local Telephony*** (MIT Press 1994). I am the co-
11 editor of ***Competition and Regulation in Telecommunications: Examining Germany
12 and America*** (Kluwer Academic Press 2000), and I am the editor of ***Is the
13 Telecommunications Act of 1996 Broken? If So, How Can We Fix It?*** (AEI Press
14 1999). I have published more than forty scholarly articles on regulation of
15 telecommunications, broadband communications, and the Internet—several of which
16 have been cited by the Supreme Court.

17 This is my second appearance as a witness before the Postal Rate
18 Commission. In this rate case I submitted direct testimony on behalf of the
19 Newspaper Association of America on the use of efficient component pricing as an
20 instrument in rate setting.

21 I am testifying on behalf of the Newspaper Association of America. The views
22 that I present are my own and not those of Georgetown University Law Center,

1 which does not take institutional positions on specific legislative, regulatory,
2 adjudicatory, or executive matters.

3 My testimony responds to the testimony of Val-Pak witness Robert W.
4 Mitchell (VP-T-1) and Mail Order Association of America witness Roger Prescott
5 (MOAA-T-1) regarding the assignment of institutional costs to Standard Enhanced
6 Carrier Route (ECR) mail. Contrary to their testimony, there is reason to believe that
7 the institutional cost contributions of Standard ECR should be higher, rather than
8 lower as they contend. I reach this conclusion based on the fact that the mail
9 system has changed significantly since 1995.

10 In particular, the leveling-off—and now decline—in the volume of First-class
11 Mail means that the Postal Service's business model can no longer presume, as it
12 has in the past, that growth in First-class Mail volume will be sufficient to fund the
13 growth of the Postal Service's network. Indeed, First-class Mail ceased to be a
14 majority of the mailstream several years ago, and the Postal Service itself projects
15 that Standard commercial mail will exceed First-class Mail in volume in the Test
16 Year. This is a profound change in the nature of the mailstream.

17 I believe that because of diversion of First-class Mail to electronic
18 communications due to the emergence of broadband communications, the Postal
19 Service can no longer rely on First-class Mail to fund its institutional costs as it has
20 in the past. Ideally, of course, the Postal Service would be trying to reduce its
21 institutional costs as much as possible so that all classes of mail could enjoy lower
22 cost coverages than at present. However, the Postal Service must fund the revenue

1 requirement that it has. Simply put, someone must pay the Postal Service's growing
2 institutional costs.

3 Therefore, decreases in Standard ECR rates as proposed by witnesses
4 Mitchell and Prescott are inconsistent with a reasonable response by the Postal
5 Service to this fundamental change in the composition of the mailstream. Such
6 proposals would be a head-in-the-sand response to the profound diversion of First-
7 Class Mail toward electronic communication. The growth of broadband subscription
8 and usage, along with the decline of First-class Mail volumes, support the testimony
9 submitted by Greeting Card Authority witness Clifton, who recommends a smaller
10 increase in First-class rates relative to the Postal Service's proposal on the grounds
11 that demand for First-class Mail has declined significantly.

12 In addition, I respond to a statement by Val-Pak witness Mitchell, in which he
13 erroneously suggested that Efficient Component Pricing is more likely to result in
14 cross-subsidization than Ramsey pricing.

15 This testimony is accompanied by rebuttal testimony by Dr. Allan Ingraham
16 (NAA-T-2), which explains that, apart from the failure to recognize the dramatic
17 changes in the mailstream since 1995, certain analyses in the testimony of
18 witnesses Mitchell and Prescott are either flawed or incomplete. Dr. Ingraham's
19 testimony explains why those analytical errors in themselves cast doubt on the
20 validity of the ultimate conclusions drawn by witnesses Mitchell and Prescott.

21 For these reasons, I conclude that the Commission should reject proposals to
22 reduce the institutional costs assigned to Standard Enhanced Carrier Route mail.

1 The emergence of broadband communications as a substitute for First-class Mail
2 means that the Postal Service's old business model can no longer work. Someone
3 must pay the institutional costs, and it is reasonable that the burden of institutional
4 costs borne by Standard Mail—the new largest class—should not decrease but, if
5 anything, should increase.

6 **I. SUMMARY OF WITNESS MITCHELL'S AND WITNESS PRESCOTT'S TESTIMONY**

7 As a major premise of their testimony, witnesses Mitchell (VP-T-1) and
8 Prescott (MOAA-T-1) both rely on testimony from past proceedings dating from 1995
9 regarding ECR cost coverage since the reclassification of third class mail into
10 Standard Regular and Standard ECR in Docket No. MC95-1.

11 **A. Witness Mitchell's Testimony**

12 Witness Mitchell recounts testimony from Dockets Nos. MC95-1, R97-1, and
13 R2000-1 to support his particular rate proposal. For example, witness Mitchell
14 claims that the Postal Service viewed the cost coverage proposed for ECR mail in
15 docket MC95-1 as "a first step." He then quotes Postal Service witness OHara's
16 rate testimony in Docket No. R97-1,² which argued that the proposed rate increase
17 for ECR mail was "below the system-wide average increase, reflecting a desire to
18 lower the very high cost coverage of this subclass."³ Finally, he discusses the direct

¹ Testimony of R. Mitchell, VP-T-1, on behalf of Valpak Direct Marketing Systems, Inc. and Valpak Dealer's Association, Inc., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 34.

² Id.

³ Testimony of D. OHara, USPS-T-30, on behalf of the United States Postal Service., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R97-1, at 34.

1 testimony of Postal Service witness Mayes in Docket No. R2000-1, who, similarly to
2 witness OHara in R97-1, proposed a below average rate increase for ECR mail in
3 an attempt "to lower the very high cost coverage of this subclass."⁴

4 Based on these and similar statements, witness Mitchell contends that the
5 Postal Service's position regarding the cost coverage of ECR and Standard Regular
6 mail was that

7 in line with the Act and accepted principles of regulatory ratesetting,
8 the coverage on Regular should be higher and the coverage on ECR
9 should be lower, that it was moving in that direction, but that it was
10 restraining itself due to the effects on mailers who are paying, and
11 will continue to pay, rates that, based on the same principles, are
12 lower than they should be.⁵

13 As a result, witness Mitchell proposes a significant reduction in the rate for ECR mail
14 and a large increase in the rates for Standard Regular mail.

15 Witness Mitchell also bases his rate proposal on estimates of the own-price
16 elasticity of demand for ECR and Standard Regular provided by Postal Service
17 witness Thress. Dr. Ingraham addresses that reliance in his rebuttal testimony
18 (NAA-RTP).

19 **B. Witness Prescott's Testimony**

20 Witness Prescott's testimony on behalf of the Mail Order Association of
21 America, which discusses the proposed rates for ECR mail only, is conceptually
22 similar to Mitchell's testimony. Witness Prescott contends that the reclassification

⁴ Testimony of V. Mayes, USPS-T-32, on behalf of the United States Postal Service, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2000-1, at 36.

⁵ Testimony of R. Mitchell, VP-T-1, on behalf of Valpak Direct Marketing Systems, Inc. and Valpak Dealer's Association, Inc., before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 35.

1 that created the ECR subclass in 1995 envisioned lower cost coverages for ECR
2 mail, that the elasticity of demand for ECR has recently increased, and that the PRC
3 should carefully consider rate increases for ECR. During cross-examination, he
4 stated that the cost coverage of ECR should be reduced from the level proposed by
5 the Postal Service.⁶

6 **II. THE PROFOUND CHANGE IN THE POSTAL MAILSTREAM SINCE 1995 DUE TO THE**
7 **DECLINE OF FIRST-CLASS MAIL VOLUME AND THE GROWTH OF BROADBAND INVALIDATES**
8 **A FUNDAMENTAL PREMISE IN THE TESTIMONY OF WITNESSES MITCHELL AND PRESCOTT**

9 Witnesses Mitchell and Prescott ignore that major changes to written
10 communications have occurred since third-class mail was split into ECR and
11 Standard Regular in Docket No. MC95-1. In particular, First-class Mail has declined
12 from being the majority of the mailstream and has even declined in absolute volume
13 in recent years. The Postal Service's own testimony projects that Standard
14 commercial mail will be the largest category of mail by the Test Year.

15 In addition, spurred in part by the tremendous growth in broadband
16 deployment in recent years, electronic communication clearly is now a viable and
17 successful substitute for First-class Mail. At the same time, however, electronic
18 communication appears complementary in demand to Standard Mail.

19 These tectonic changes in the demand for electronic communications and
20 mail delivery have profound ramifications for the Postal Service's ability to fund its
21 operations in the future. The decline of First-class Mail and the ascendancy of
22 Standard Mail means that the Postal Service can no longer rely on its former

⁶ Tr. 25/9071.

a

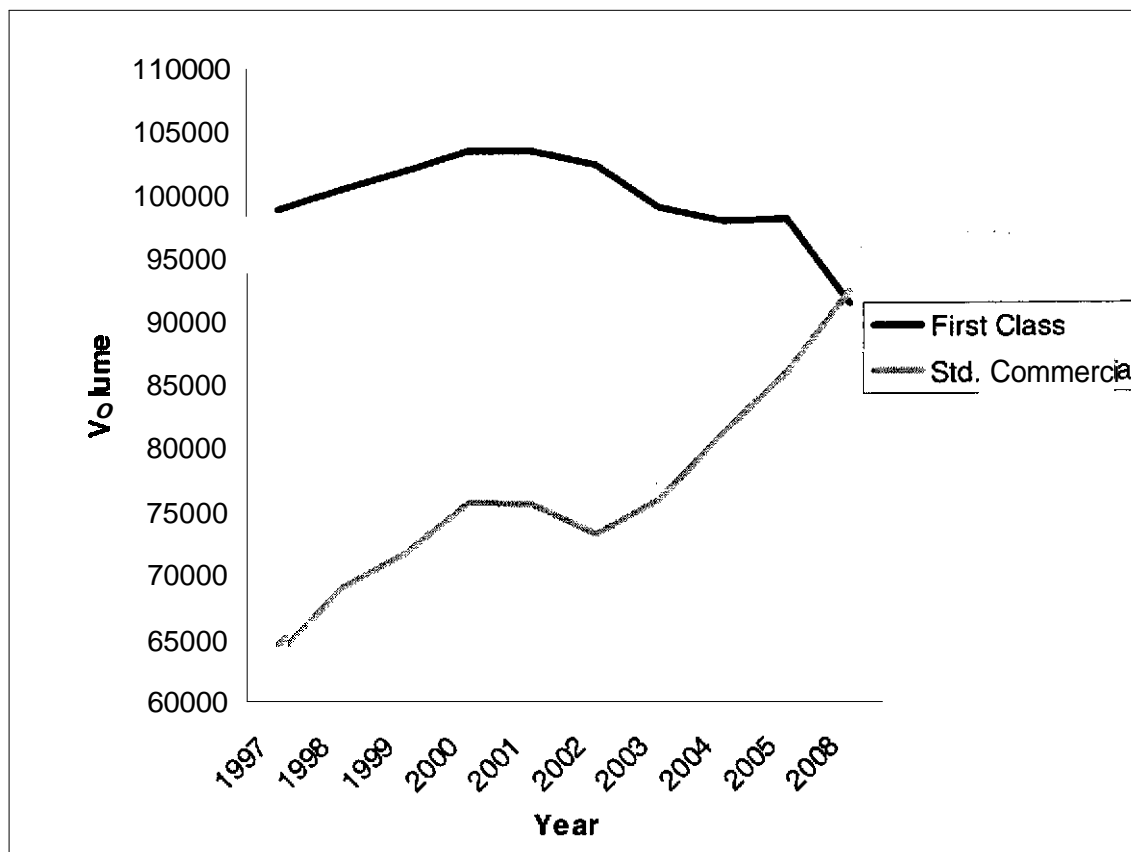
1 business model, in which growth in the demand for First-class Mail was expected to
2 pay the bulk of the institutional costs of the postal network.

3 So the Postal Service must find a new business model. Since the Postal
4 Service's overhead costs must be recovered somewhere, it is incumbent that the
5 Service ask how other classes of mail might cover the shortfall. Standard Mail, now
6 the largest category of mail, is the candidate with the most volume over which these
7 institutional costs could be recovered. Reducing the cost coverage of Standard ECR
8 mail is not a responsible reaction to the financial challenges that now confront the
9 Postal Service.

10 A. First-class Mail ~~Is~~ No Longer the Largest Mail Class

11 The emergence of electronic communications as a viable competitor to First-
12 Class Mail has caused major changes to the mailstream in the United States. This
13 can be seen from the recent volume figures presented in Figure 1:

Figure 1: Volume of First-class and Standard Commercial Mail Since 1997
(millions of pieces)



Source: Source:USPS-LR-L-63 (worksheet "GFY Volumes" within the workbook "Volumes.xls"); USPS-T-7; tbl 1 at 9.

The data in Figure 1 indicate that First-class Mail volume has declined since 1997.

The Postal Service's own testimony indicates that it will continue to do so. At the same time, the volume of Standard Commercial mail has steadily increased since at

least 1997. Postal Service witness Thress has estimated that by 2008, First-class

will no longer be the largest class of mail and will be surpassed, in volume, by

Standard commercial Mail. First-class Mail has already been surpassed by

Standard Mail in rate of volume growth.

1 This fundamental change in the nature of the mailstream appears to have
2 happened relatively quickly. I am advised that no postal rate case has been fully
3 litigated since Docket No. R2000-1, which means that the Commission has not had
4 a real opportunity to consider these changes and their implications for postal pricing.

5 At the least, however, it is reasonable to surmise that comments made in
6 Docket No. MC95-1 and subsequent rate cases regarding ECR cost coverages were
7 made when First-class Mail predominated in the system and the Postal Service
8 adhered to a business model that is now outdated. Accordingly, testimony in those
9 past cases regarding the appropriate cost coverages for Standard Commercial
10 mailers cannot be considered relevant to this rate case. Put differently, by relying on
11 rate testimony that is at times over a decade old, witness Mitchell implicitly assumes
12 that the economic environment of the current mailstream resembles the economic
13 environment that existed a decade ago. It does not.

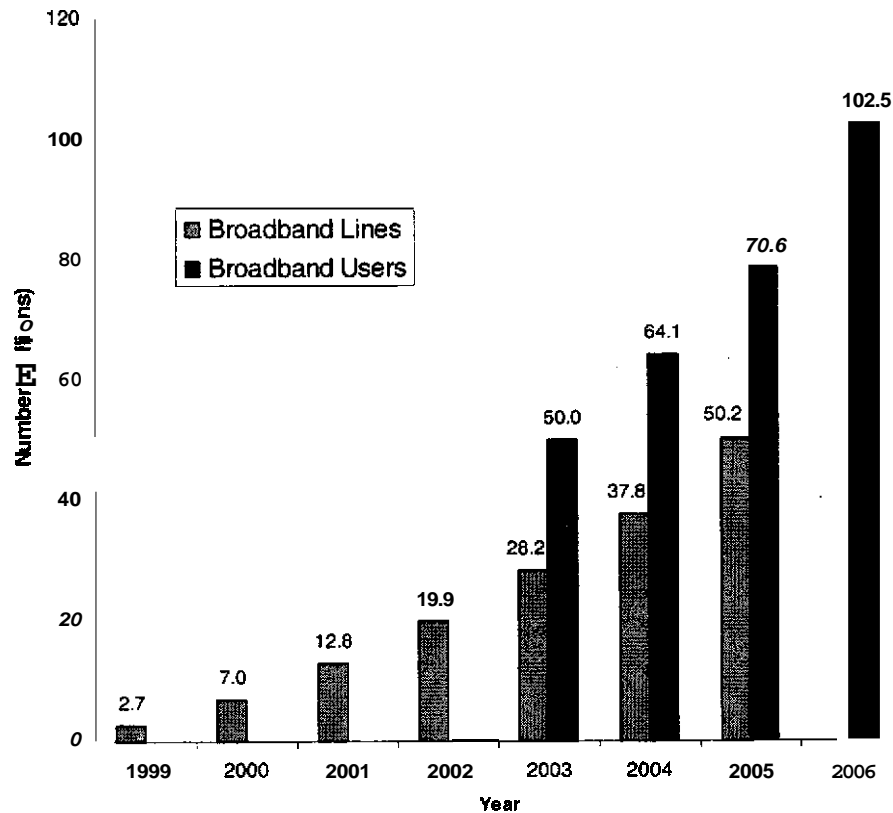
14 B. The Growth of Broadband Penetration Has Enabled Consumers to
15 Substitute Away from Written or Paper Communication

16 In responding to the testimony of witnesses Mitchell and Prescott, it is
17 appropriate to review how the rapid growth of broadband availability and broadband
18 penetration has contributed significantly to the diversion of First-class Mail to
19 electronic communications. These trends suggest that the Postal Service's old
20 business model has little prospect of future vitality.

21 Since 1999, the usage of high speed Internet access has increased
22 dramatically. Figure 2 shows the growth in broadband lines (typically one per

1 household) and broadband users (typically more than one per household) from 1999
 2 through 2006.

3 **FIGURE 2: BROADBAND LINES AND BROADBAND USERS, 1999-2006**



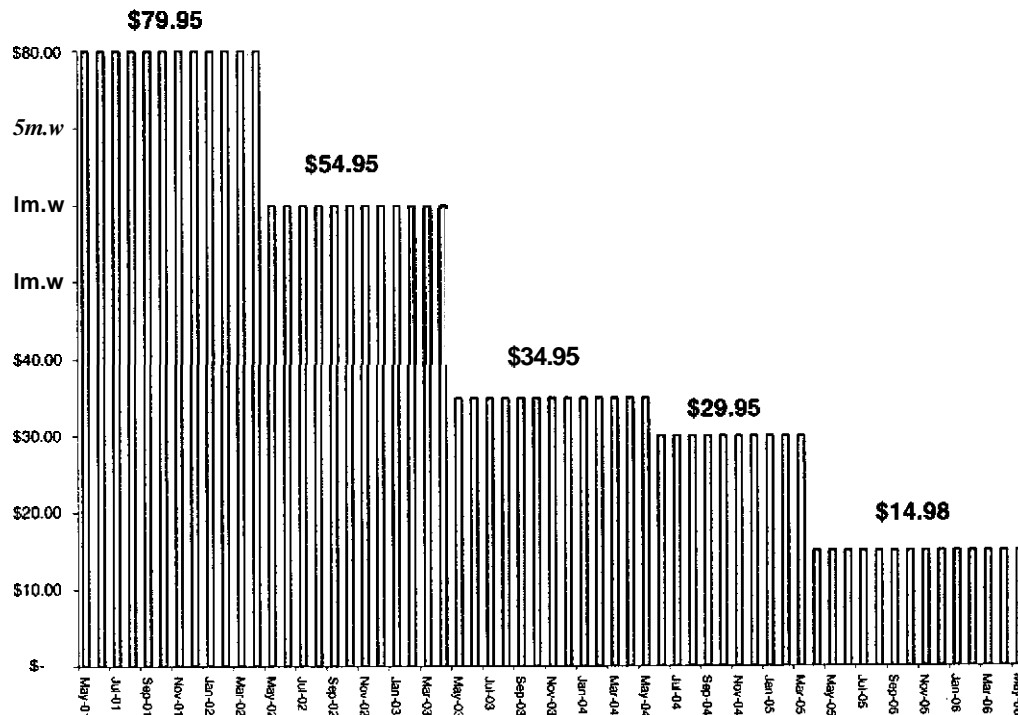
4
 5 Source: WIRELINE COMPETITION BUREAU, FCC, HIGH SPEED SERVICES FOR
 6 INTERNET ACCESS: STATUS AS OF DEC. 31, 2005 (2006); Q4 2003 NetRatings
 7 Earnings Conference Call - Final, FAIR DISCLOSUREWIRE, Feb. 26, 2004; U.S.
 8 Broadband Penetration Tops 40%, EDITOR AND PUBLISHER, Sept. 28, 2005;
 9 Carol Wilson, *Nielson: Broadband Use Near 75%*, PRISM INSIGHT, Jun. 22,
 10 2006.
 11

12 Specifically, the adoption of residential broadband Internet access, as measured by
 13 residential broadband lines into individual households, has increased from only 1.79
 14 million in December 1999 to 42.94 million by December 2005, an increase of nearly
 15 2,300 percent. Furthermore, the number of Internet users with access to broadband
 16 Internet service at either home or work has increased substantially. The United

1 States now has 102.5 million broadband users, whereas there were **only** 50 million
2 users in 2003. There can be no doubt that the continued consumer adoption of
3 broadband services indicates that the Internet now plays a vastly more important
4 role in the life of the average U.S. consumer than it did even a few years ago.

5 The price of broadband access service has fallen dramatically in the United
6 States. Figure 3 shows the decrease in Verizon's monthly price of 1.5 Mbps DSL
7 access from May 2001 to May 2006.

1 FIGURE 3: VERIZON'S MONTHLY PRICE FOR 1.5 MBPS DSL ACCESS, MAY 2001-MAY 2006



2
3 Source: BEAR STEARNS, MARCH BROADBAND BUZZ: A MONTHLY UPDATE ON CRITICAL
4 BROADBAND ISSUES 6 (2006)

5 Note: In April 2005, Verizon began offering 3.0 Mbps DSL access for the same price
6 that it had been offering 1.5 Mbps DSL access, thus doubling the performance of its
7 entry-level DSL product. Figure 1 treats this repricing as halving the price of 1.5
8 Mbps DSL access. See Press Release, Verizon Online Offers Twice the
9 Speed of Its Basic Consumer DSL Service For the Same Price (Apr. 4, 2005),
10 <http://newscenter.verizon.com/proactive/newsroomrelease.vtml?id=90158>

11 As Figure 3 shows, the monthly price of 1.5 Mbps DSL access from one of the
12 largest broadband providers in the United States decreased so sharply that the price
13 for a 1.5 Mbps offering in May 2006 was only 18.7 percent of the price of that
14 offering in May 2001.

15 The rapid decline in the price of broadband services and the significant
16 acceleration in the availability and adoption of those services indicate that individuals
17 and businesses in the United States increasingly rely on electronic communication.

18 Because electronic communication is a substitute for First-class Mail, it is erroneous

1 to assume that the Postal Service can continue to fund its increasing institutional
2 costs through First-class Mail as it has in the past. If a First-class mailer has
3 already switched to electronic communication, it is indicating that use of the
4 electronic substitute generates substantially higher net benefits than does the
5 continued use of First-class Mail. A simple example involving the diversion of First-
6 Class Mail to electronic bill payment illustrates this point.

7 Suppose an Internet user works 2000 hours during a year to earn an annual
8 salary of \$30,000. This person's implicit wage is **\$15** per hour, or \$0.25 per minute.
9 Suppose further that the average bill (from a utility or credit card issuer, for example)
10 takes 3 more minutes to pay with a paper check or money order than it would if the
11 consumer were to pay through electronic bill payment. On these hypothetical facts,
12 the consumer's total cost to mail a bill via First-class mail is the cost of postage
13 (\$0.39) plus the opportunity cost of the consumer's time (3 minutes x \$0.25 per
14 minute = \$0.75).⁷ Therefore, in this example the consumer's total opportunity cost of
15 paying a single bill via First-class Mail is \$1.14.⁸ If this consumer were to pay twelve
16 bills per given month, the opportunity cost of paying those bills via First-class Mail
17 would be \$13.68 per month, or \$164.16 per year. Consequently, for this consumer to
18 be indifferent to paying bills electronically or paying them through First-class Mail,

⁷ Valuing a consumer's time at his or her implicit wage rate is a standard practice in economic analysis. See, e.g., **MICHAEL L. KATZ & HARVEY S. ROSEN, MICROECONOMICS** 200-01 (3d ed. 1998). For example, studies of the social cost of congestion externalities value the cost of waiting at the implicit wage rate.

⁸ This hypothetical estimate of the consumer's opportunity cost of paying bills by First-Class Mail is conservative. The average hourly wage in the United States in December 2005 was actually higher, \$16.34, which would imply an opportunity cost of time per bill paid of \$0.82, plus the 39 cent stamp, for a total opportunity cost of \$1.21 per bill paid. See 2006 **ECONOMIC REPORT OF THE PRESIDENT** 338 Table B-47 (hours and earnings in private nonagricultural industries, 1959-2005).

1 the consumer's bank would need to charge the consumer more than \$164.16 per
2 year for the option to pay bills electronically, which is not, and is unlikely to become,
3 common practice.

4 This example conveys the policy conundrum that the Postal Service
5 increasingly faces. When consumers defect from First-class Mail to electronic forms
6 of communication, the customers who remain are the *inframarginal* users of First-
7 Class Mail, who have fewer competitive alternatives. It seems contrary to the intent
8 of the postal monopoly for the Postal Service to keep raising the price charged to
9 these inframarginal users of First-class Mail, for the purpose of having a postal
10 monopoly in the first place is to keep the delivery of letters affordable so as to
11 produce positive network externalities of communication. Moreover, one can
12 reasonably argue that a downward spiral by which the remaining consumers of First-
13 Class Mail would be forced to pay continually increasing cost coverage would be
14 inconsistent with "the establishment and maintenance of a fair and equitable
15 schedule" that section 3622(b) prescribes.⁹

⁹ Demographic evidence on the marginal consumer of broadband access can possibly shed light on another aspect of the fairness and equity of increasing the cost coverage of First-class Mail. In November and December of 2005, the Pew Internet and American Life Project surveyed U.S. households on their decision to subscribe to Internet service, including dial-up Internet service. See John Horrigan, *Home Broadband Adoption 2006*, PEW INTERNET AND AMERICAN LIFE PROJECT, May 28, 2006, http://www.pewinternet.org/pdfs/PIP_Broadband_trends2006.pdf, at i. Relative to all broadband subscribers, marginal broadband subscribers had less income and less education. Such a finding implies a consumer's willingness to pay for broadband is positively related to his income and education. If demographic characteristics of inframarginal consumers of First-class Mail resemble those of marginal (rather than inframarginal) consumers of broadband access, then it would follow that increasing the cost coverage of First-class Mail would be analogous to imposing a regressive tax. Conversely, reducing that cost coverage would be analogous to imposing a progressive tax.

1 C. First-class Mail, But Not Standard Mail, Has Experienced Considerable
2 Erosion of Demand **Due** to Substitution to Electronic Communication

3 Other witnesses in this case have recognized these trends in broadband
4 deployment and adoption, and in electronic communication substitution for First-
5 Class Mail, although they differ as to the extent of the trend. For example, the
6 Postal Service's volume forecasting witness found that "[t]he Internet has had a very
7 strong negative effect on First-class single-piece letters volume, explaining annual
8 losses that have averaged more than 4.5 percent per year over the past decade."

9 Furthermore, witness Thress explained that the Internet has significantly
10 dampened the demand for First-class workshared letters. In particular, he found that
11 a variable that captures broadband subscribers, lagged by one year, reduces the
12 volume of First-class workshared letters in a statistically and economically
13 significant manner." Specifically, he found that broadband adoption "is projected to
14 lead to a further decline of an additional 8.6 percent in First-class workshared letters
15 volume over the next three years."¹²

16 As an expert on the market for broadband access, I note here my belief that
17 witness Thress has likely underestimated the true effect of electronic diversion on
18 First-class Mail volumes. The problem lies in his use of the one-year lagged
19 measure of broadband subscribers in his workshared mail volume forecasting
20 model. The lagged variable trails reality by a year. That might not be serious if

¹⁰ Testimony of T. Thress, USPS-T-7, on behalf of the United States Postal Service, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 60.

¹¹ *Id.* at 70, 73.

¹² *Id.* at 70.

subscriptions levels in the most recent years did not differ much from those in the earlier years. A quick glance at Figure 2 above confirms that the broadband subscriptions and users are dramatically higher in 2005 and 2006 than in 2004. It is widely believed that a major stimulus to investment and competition in broadband adoption began in 2005, when the FCC deregulated DSL service¹³ and the Supreme Court affirmed that cable modem service was an unregulated information service.¹⁴ It is also highly significant in my opinion that, in an experiment begun in August 2006, Google now offers the 72,000 residents of Mountain View, California free broadband Internet access service—which, of course, is implicitly funded by Google's advertising revenues." These regulatory and business developments are likely to accelerate broadband adoption relative to the trend observed before 2005.

For these reasons, it is my opinion as a telecommunications expert, that it is unlikely that Witness Thress has adequately measured the most important of the recent effects of, and trends in, electronic diversion of First-class Mail. However, the important point is that his testimony recognizes the trends.

In addition, witness Clifton, testifying on behalf of the Greeting Card Association of America, also found that the Internet has significantly dampened the demand for First-class Mail. This basic agreement exists despite his disagreement with witness Thress over the extent to which First-class Mail demand has been

¹³ **Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Report and Order, CC Dkt. No. 02-33, 20 F.C.C.R. 14,853 (2005).**

¹⁴ **National Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 974 (2005).**

¹⁵ **John Markoff, Google Says It Has No Plans for National Wi-Fi Service, N.Y. TIMES, Aug. 15, 2006, at 7.**

1 weakened by electronic communications.¹⁶ Witness Clifton asserted that witness
2 Thress did not properly control for the effects of the Internet in his demand equations
3 and that the Thress estimates consequently understate the effect of electronic
4 communications on First-class Mail demand.”

5 Therefore, although there is debate in this proceeding regarding the extent to
6 which First-Class Mail has been diverted toward electronic communication, there is
7 no debate over the fact that electronic diversion exists and has had, and will
8 continue to have, an effect on First-class Mail that is significant in both an economic
9 and statistical sense.

10 In contrast to First-class Mail, there is no evidence in this rate case that
11 Standard Regular or ECR mail have experienced statistically significant diversion at
12 the hands of electronic communication. Furthermore, the relationship between the
13 demand for either Standard Regular or ECR mail and electronic communication is
14 likely to be structurally different from the relationship between First-class Mail and
15 electronic communications.

16 In particular, witness Thress’ testimony provided a descriptive framework for
17 the consideration of the relationship between the Internet and ECR mail. Thress
18 explained that “[a]t one level, the Internet and the mail are competitors for limited
19 advertising dollars.”¹⁸ However, he also stated that “[i]n some ways, the Internet

¹⁶ Testimony of J. Clifton, GCA-T-7, on behalf of the Greeting Card Association, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 2.

¹⁷ *Id.*

¹⁸ Testimony of T. Thress, USPS-T-7, on behalf of the United States Postal Service, before the Postal Rate Commission, Postal Rate and Fee Changes, Dkt. No. R2006-1, at 98.

1 complements direct-mail advertising by providing a network for making catalog
2 purchases, substituting for telephone orders, for example.”¹⁹ Although Thress stated
3 that the Internet may pose a long-run threat to ECR mail, he concludes that
4 electronic communication and ECR mail may be predominantly complements in the
5 time frame considered for the instant rate case.”

6 Thress’ econometric analysis of ECR mail demand supports his conclusion
7 regarding the lack of strong substitution between ECR mail and electronic
8 communication. In his ECR equation, Thress included a variable for Internet
9 advertising expenditures. Although the regression coefficient on that variable was
10 negative, it was not statistically significant at the 95 percent confidence level.²¹ That
11 is, at a reasonable level of statistical accuracy, one cannot reject the statistical
12 proposition that Internet advertising does not affect the demand for ECR mail.

13 **D. Trends in the Volume of First-class and Standard Mail Since 1995 Indicate**
14 **that the Burden of Institutional Costs Should Be Transferred from First-**
15 **Class Mail to Standard Mail**

16 First-class Mail has long borne a significant majority of the institutional costs
17 burden, and under the Postal Service’s proposal it will continue to fund a majority of
18 institutional costs. A likely effect of reducing the cost coverage of ECR mail would
19 be to increase even more the burden on First-class Mail.²² Given the recent decline

¹⁹ Id. at 99.

²⁰ Id. at 99-100.

²¹ Id. at 122 (recording a t-statistic of -1.709 on the Internet Advertising Expenditures variable).

²² Witness Prescott does not say what classes of mail should make up for a reduction in ECR’s cost contribution. I recognize that witness Mitchell proposes to shift \$1 billion of institutional

1 in the use of First-class Mail at the hands of electronic communication, this is the
 2 wrong approach and the Commission should consider lessening, not increasing, the
 3 institutional cost burden placed on First-class Mail and begin to move that burden to
 4 other mail.

5 In an interrogatory response, Postal Service witness OHara listed the cost
 6 coverage index (that is, cost coverage relative to the systemwide average) for First-
 7 Class and Standard mail since 1994. Table 1 lists the cost coverage and the system
 8 wide average cost coverage as reported in OHara's response to VP/USPS-T31-9.

9 TABLE 1: COST COVERAGE INDEXES FOR FIRST-CLASS AND STANDARD MAIL SINCE 1995

Year	System Average Cost Coverage	First-class Mail Cost Coverage Relative to Average			Standard Mail Cost Coverage Relative to Average		
		Total	Single Piece	Presort	Total	Regular	ECR
1996	164	1.09	0.94	1.60	0.98	0.83	1.38
1997	181	1.13	1.01	1.52	0.93	0.80	1.30
1998	179	1.16	1.04	1.54	0.91	0.76	1.34
1999	168	1.17	1.04	1.54	0.89	0.78	1.19
2000	171	1.18	1.02	1.64	0.91	0.79	1.28
2001	171	1.18	1.01	1.62	0.91	0.79	1.36
2002	173	1.20	1.02	1.65	0.90	0.79	1.29
2003	186	1.17	0.97	1.69	0.94	0.82	1.41
2004	185	1.19	0.97	1.73	0.93	0.84	1.32
2005	176	1.19	0.97	1.71	0.97	0.91	1.16
2006	176	1.22	0.99	1.72	0.99	0.92	1.18
2007	181	1.21	0.98	1.71	0.98	0.93	1.16
2008	189	1.21	0.99	1.66	0.98	0.94	1.14

10 (Source: Response of United States Postal Service Witness O'Hara, VP/USPS-T31-7-9, 9.

costs from ECR to Standard Regular only, but I am skeptical that the Commission would make such an adjustment without offloading some of the burden to First-Class Mail.

1 The data in Table 1 indicate that the cost coverage for ECR relative to the
2 system-wide average has in fact declined since 1996 (which, incidentally, is
3 consistent with the recommendations of witnesses Mitchell and Prescott, who argue
4 that it should have declined even more) and the cost coverage for Standard Regular
5 relative to the system-wide average has increased. On the whole, however, the cost
6 coverage index of Standard mail has remained relatively unchanged at slightly below
7 the system average cost coverage since 1996. In particular, the cost coverage
8 index of Standard mail was 0.98 in 1996 and would be the same in 2008 under the
9 Postal Service's proposal and costing methodologies.

10 While the cost coverage of Standard Regular mail has increased since 1995,
11 the volume of Standard Regular mail has steadily increased as well despite the
12 increase in its cost coverage. Additionally, ECR volume has remained relatively
13 constant as the Postal Service has steadily decreased its relative cost coverage.
14 These data suggest that Standard mail would be able to bear a portion of the
15 institutional cost burden currently borne by First-class Mail but that will be lost as
16 electronic substitution occurs.

17 In contrast to Standard mail, between 1996 and 2008, the cost coverage
18 index of First-class Mail has increased, relative to the systemwide average, from
19 1.09 to 1.21. Furthermore, some of this increase occurred between 2000 and 2006,
20 a period in which broadband penetration grew by more than 2000 percent as
21 electronic communication in the United States blossomed and First-class Mail
22 became in increasing jeopardy to diversion. It is clear that since 1995, the Postal
23 Service has more aggressively increased the institutional cost contribution for First-

1 Class Mail (as measured by cost coverage percent relative to the average) than it
2 has for Standard Commercial mail.

3 **E. A Reasonable Response Would Be To Shift a Portion of the Institutional**
4 **Costs Burden Borne by First-class Mail to Standard Commercial Mail**

5 Given the data presented above, I respectfully disagree with the testimony of
6 witnesses Mitchell and Prescott for two main reasons. First, the mailstream and the
7 economic factors that affect First-class volume have fundamentally changed since
8 1995. The emergence of electronic communications as a significant competitor to
9 First-class Mail has decreased the Postal Service's ability to look to First-class Mail
10 when it needs additional revenues to cover its institutional costs. As a result, other
11 classes—and, due to its sheer size, Standard Mail in particular—must play an
12 increasingly important role in the funding of institutional costs both now and in the
13 future. Statements from past cases that suggest otherwise do not reflect the current
14 reality and have little relevance today.

15 Second, given that the Postal Service has already lessened the relative cost
16 coverage for ECR, and given that First-class Mail has seen considerable erosion at
17 the hands of electronic communications, proposals to decrease ECR cost coverage
18 still further seem to go in the wrong direction. Instead, it would seem wiser, with the
19 demise of the Postal Service's old business model, to begin to increase, at the
20 margin, the institutional cost contribution borne by Standard Commercial mail rather
21 than risk further substitution away from First-class Mail and toward electronic
22 communications. Standard Commercial mail will soon exceed First-class Mail in

1 volume. ECR mail will, in addition to Standard Regular, have to bear an increasing
2 burden of the contribution to the recovery of institutional costs on an ongoing basis.

3 **III. WITNESS MITCHELL INCORRECTLY STATES THAT RAMSEY PRICING LEADS TO**
4 **LESS CROSS-SUBSIDIZATION THAN EFFICIENT COMPONENT PRICING**

5 Val-Pak witness Mitchell incorrectly states that Ramsey pricing leads to less
6 cross-subsidization than Efficient Component Pricing (ECP). He does so in his
7 response to interrogatories submitted by Advo, Inc.,²³ where he disagrees with
8 testimony submitted by Dr. Panzar regarding Ramsey pricing and ECP in this
9 proceeding. In particular, witness Mitchell states that ECP is more likely than
10 Ramsey pricing to result in cross-subsidization:

11 I do not see that there is any meaningful likelihood of Ramsey
12 pricing causing a cross subsidy. Unless there are significant
13 differences in elasticity, which is not known to be the case among
14 the categories in either Regular or ECR mail, a Ramsey solution
15 goes in the direction of equal percentage markups over costs, which
16 assures that each price is well above costs. On the other hand,
17 ECPR produces different percentage markups, and is thus more
18 likely than Ramsey to get into cross-subsidization territory.²⁴

19 This statement is inconsistent with the principles of both Ramsey pricing and ECP.
20 In particular, for Mitchell's statement to be true, he is implicitly assuming that the
21 Postal System is governed by constant marginal costs. That is, the Ramsey pricing
22 rule involves a percentage markup over *marginal* costs for each good produced.²⁵ If

²³ Response of Vaipak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Witness Mitchell, ADVO/VP-T1-1-14, 10.

²⁴ *Id.*

²⁵ This is the special case of the Ramsey pricing rule in the event that there are no substitutes or complements among the set of goods produced. See William J. Baumol, *Ramsey Pricing*, in 4 THE NEW PALGRAVE DICTIONARY OF ECONOMICS 49 (John Eatwell, Murray Milgate & Peter Newman, eds., Stockton Press, 1991).

1 marginal costs are everywhere constant, then Ramsey pricing will generally avoid
2 cross subsidization.²⁶ However, were the multiproduct firm to have declining
3 marginal costs, cross subsidization would be possible. Specifically, because
4 Ramsey prices are calculated based on marginal prices at *the optimal level of*
5 *output*, Ramsey prices consider only the multiproduct firm's cost function at specific
6 points. Were a portion of the multiproduct firm's marginal cost curve for good x
7 rapidly declining over a range of outputs for x, and were the optimal quantity of x to
8 exceed that range of output under which good x's marginal cost curve were
9 decreasing, it would be possible for Ramsey pricing to cover the marginal cost of the
10 last unit produced but not the average incremental costs of all units produced. As a
11 result, good x would require subsidization by another good produced by the
12 multiproduct firm.

13 By contrast, ECP ensures that the multiproduct firm is able to cover at least
14 its total incremental costs from the production of the good in question.²⁷ Total
15 incremental cost to the multiproduct firm of producing good x is merely the total cost
16 to the multiproduct including the production of x less the total cost to the multiproduct

²⁶ *Id* (stating that the marginal cost pricing rule is achieved in instances of constant returns to scale over the relevant range of outputs).

²⁷ See, e.g., William J. Baumol & J. Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 YALE J. ON REG. 171, 187-89 (1994).

1 firm without the production of x .²⁸ Calculated correctly, ECP therefore ensures that
2 cross subsidization of goods produced by the multiproduct firm will not occur.²⁹

3 Hence, I disagree with witness Mitchell. The Commission should conclude
4 that ECP, rather than Ramsey pricing, is less likely to result in cross subsidization.

5 CONCLUSION

6 Based on my testimony and that of Dr. Ingraham (NAA-RT-2), the
7 Commission should reject the proposals by Val-Pak witness Mitchell and MOAA
8 witness Prescott to reduce the institutional cost contribution of Standard ECR mail.

9 First, as I explained above, the postal marketplace has changed dramatically
10 in the past decade. Many of the statements from earlier postal proceedings upon
11 which witnesses Mitchell and Prescott rely are outdated, and are not sound
12 guidance for the Commission to use in this case. In particular, the Postal Service's
13 business model of relying on growth in First-class Mail to pay for the great majority
14 of the institutional costs of the system is not sustainable because First-class mail
15 volume is now declining, not growing. Standard Mail will surpass First-class Mail in
16 volume by the Test Year. The substantial recent deployment, and continuing
17 consumer adoption, of broadband communications has increased the availability and
18 variety of electronic communication substitutes for First-class Mail and these trends

²⁸ *Id.* at 176-77.

²⁹ See, e.g., Gerald R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AMER. ECON. REV. 966 (1975); Gerald R. Faulhaber, *Cross-Subsidy Analysis with More than Two Services*, 1 J. COMPETITION & ECON. 441 (2005).

1 are likely to continue. In contrast, electronic communications may be
2 complementary to Standard mail.

3 Thus, pricing proposals that require First-class Mail to bear a large majority of
4 institutional costs are flawed. Standard mail, which is taking its place as the largest
5 type of mail, can be expected to have to bear more of the institutional costs of the
6 system. Accordingly, the proposals of witnesses Mitchell and Prescott should be
7 rejected.

8 Finally, witness Mitchell incorrectly has asserted that Efficient Component
9 Pricing is more likely to lead to cross-subsidization than Ramsey pricing. This is
10 erroneous, for the reasons I have explained above.

1 CHAIRMAN OMAS: That now brings us to oral
2 cross-examination. Four requests have been made for
3 oral cross.

4 Mr. McLaughlin, would you introduce yourself
5 and begin, please?

6 MR. McLAUGHLIN: Thank you, Mr. Chairman.
7 Tom McLaughlin representing Advo, Inc.

8 CROSS-EXAMINATION

9 BY MR. McLAUGHLIN:

10 Q Good afternoon, Mr. Sidak.

11 A Good afternoon.

12 Q I would like to start by just asking some
13 questions about the scope of your testimony. You did
14 file testimony back in September that was direct
15 testimony, in essence, in the form of a rebuttal to
16 the Postal Service proposal. Is that correct?

17 A I filed direct testimony.

18 Q It, in essence, rebutted certain aspects of
19 the Postal Service's proposal. Is that correct? It
20 specifically dealt with the rate-structure issues
21 within the enhanced carrier route subclass.

22 A Yes. I wouldn't characterize it as rebuttal
23 testimony because it was the direct round.

24 Q Okay. Right. And in that testimony, as I
25 recall, you did not really discuss the ECR cost

1 coverage or criticize the Postal Service's proposed
2 ECR cost coverage. Is that correct?

3 A Yes. I think that's correct.

4 Q Okay. Your rebuttal testimony; it rebuts
5 Valpak Witness Mitchell -- is that correct? -- and,
6 specifically, his proposal to reduce the ECR cost
7 coverage. Is that correct?

8 A Yes.

9 Q You are not, in this testimony here,
10 rebutting the Postal Service's proposed cost coverage,
11 are you, for purposes of this case?

12 A No, I'm not. My testimony is of a more
13 qualitative nature. I'm not putting forward any
14 specific numerical proposal for a rate.

15 Q Okay. Thank you. Turn to page 9 of your
16 testimony, please. And I know you filed some errata,
17 and, I confess, I didn't look at it and check it
18 against your testimony here. I just want to double-
19 check a couple of things on here.

20 First of all, you'll see you have a table
21 there showing the volume comparisons chart, and on
22 line number 2, it says: "Millions of pieces --
23 check." Is that a typo, I presume? Should "-- check"
24 come out?

25 A It should come out. I just wanted to --

1 Q It did come out. Okay.

2 Now, also, then, on that same chart, if you
3 look down at the X axis, which has a list of years, I
4 see everything going in one-year increments up to the
5 year 2005, and then, in the very next step, it skips
6 three years up to 2008. Should it be 2008, or is that
7 2006?

8 A I don't know the answer without looking at
9 the data in the chart.

10 Q Is it possible that it really should be
11 2008, but that, in terms of the scale, you just
12 omitted 2007. So, therefore, the 2008 point on the
13 chart should be further out to the right.

14 A I would have to look at the data behind the
15 chart to answer your question.

16 Q The reason I ask is because I noticed that
17 after 2005, going from 2005 to the next data point,
18 there seemed to be a very sharp drop in first class,
19 and I was wondering if that was simply a problem with
20 the scale of the chart; in other words that perhaps
21 you omitted two years in the X axis line.

22 A As I look at line 10 on that page, the
23 sentence reads: "Postal Service Witness Thress has
24 estimated that by 2008 first class will no longer be
25 the largest class of mail and will be surpassed."

1 So on the diagram on that page, in year 2008
2 there is the cross-over point between first class and
3 standard commercial, which would correspond with
4 Witness Thress's estimate.

5 Q Right. Okay.

6 A So now that I re-read this, I have greater
7 confidence that it is actually 2008, not 2006, which
8 is the last year on the horizontal axis.

9 Q Right.

10 A It could have been scaled out.

11 Q And so, visually, the first-class volume
12 figure would not drop as sharply as it appears to in
13 that column because you have omitted two years in the
14 X axis. Is that correct?

15 A I'll concede that, yes.

16 Q Okay. I was just confused myself.

17 Now then, on that same chart, one of the
18 lines is for standard commercial mail.

19 A Yes.

20 Q And that's the lighter-shaded, lower line
21 that rises fairly sharply.

22 A Yes.

23 Q Standard commercial consists of two
24 subclasses, doesn't it, the regular subclass and the
25 ECR, enhanced carrier route, subclass?

1 A Yes. That's my understanding.

2 Q If you look at the growth from 1998 up to
3 2005, how much of that growth is due to enhanced
4 carrier route?

5 A I don't know the number off the top of my
6 head. I remember seeing the annual data broken down
7 for ECR and regular in one of the pieces of direct
8 testimony, I believe, filed by a Postal Service
9 witness, but I don't remember --

10 Q So you don't know how much of that increase
11 is due to enhanced carrier route versus due to growth
12 in the regular subclass.

13 A I recall that if you plotted the two series
14 of data, standard ECR and standard regular, and you
15 plotted their volumes over time, there would be
16 volatility, and one is more volatile than the other.
17 I say, if you plotted. I'm just eyeballing it from --

18 Q You're talking about the two separate
19 subclasses.

20 A Yes. They don't move in exact parallel.

21 Q Okay. And is the less-volatile one Standard
22 A regular?

23 A I don't recall right now.

24 Q You don't know if Standard A regular was the
25 subclass that has increased virtually every year over

1 that span of time.

2 A No. The purpose of my testimony is not to
3 get into specifics about rates for particular
4 subclasses in the sense of how they have behaved over
5 time with respect to one another so much as it is to
6 give a general overview of what has happened to the
7 demand for classes of mail because of electronic
8 substitution.

9 Q Well, except that I believe that -- I'll
10 have to find the page here -- I do recall somewhere
11 here when you talk about the future that you talk
12 about standard commercial mail, including enhanced
13 carrier route mail, must have increased contribution
14 over the long term. Do you recall that?

15 A Yes.

16 Q So you are distinguishing, to some extent,
17 ECR and regular.

18 A Yes. To that extent, I am.

19 Q Well, the source of your volume figures here
20 is Witness Thress. Is that right?

21 A Yes. It's T-7.

22 Q Would you accept, subject to check, that
23 Witness Thress's volumes upon which your volumes are
24 based show that between 1998 and 2005 that ECR volume
25 has declined?

1 A I'll accept that, subject to check, yeah.

2 Q And would you accept, subject to check, that
3 between that same period, 1998 to 2005, that Standard
4 A regular volume has increased by more than 50
5 percent?

6 A I'll accept that, subject to check.

7 Q And if those two statements are correct,
8 would that then mean that on your chart here on page 9
9 that the entirety of that upward trend in standard
10 commercial volumes is due to Standard A regular rather
11 than to Standard A ECR?

12 A I would want to go back and see if there are
13 any other categories of mail that might be influencing
14 the plotting of the line, but, subject to check, I
15 would say yes.

16 Q So they have had substantially different
17 volume histories over the time period.

18 A Yes. I'll accept that.

19 Q And that's even though the Standard A ECR
20 volume declined over that period, even though cost
21 coverages were not increased over that period. Is
22 that correct? Strike that. Let me go on to something
23 else here.

24 You talk a lot about demand, and you also
25 mention price elasticity in your testimony. Demand

1 and elasticity are not the same concept, are they?

2 A No.

3 Q Years ago, perhaps 100 years ago, the
4 primary form of personal transportation, a primary
5 form was the horse and buggy, and that was later
6 superceded by the automobile. Now, today, if you
7 wanted to open up a horse and buggy dealership other
8 than in Amish country, what would you have to charge,
9 what kind of a cost coverage or markup would you have
10 to charge, to get people to convert from automobiles
11 to horse and buggies?

12 A Well, I don't know the precise answer to
13 your question, but it could be that -- well, as a
14 matter of economic theory, what you look at is the
15 price that would attract the marginal consumer, and
16 many consumers, even at a price of zero, there would
17 not be a demand for horse and buggy.

18 Q Yes. In fact, that points to the fact that
19 demand is not purely a function of price. Demand is a
20 function of many other factors, including differences
21 in value of service.

22 A The formal definition that you'll find in
23 any graduate micro-economics textbook for demand is
24 that demand is a function of the price of the
25 particular good that you're looking at plus the price

1 of all other goods consumed by that consumer plus the
2 consumer's income. That is the textbook presentation
3 of a demand function.

4 Q And in the case of the horse and buggy, the
5 diversion from horse and buggies to automobiles was
6 not a function of the price of horse and buggies, was
7 it? Wasn't it a function of the value and qualities
8 of automobiles that horse and buggies could not
9 duplicate?

10 A Well, I think you're inviting me to
11 speculate about horses and buggies and automobiles.
12 So I don't know if I should speculate or not. I don't
13 know if it's useful for the Commission.

14 Q Well, there is such a thing as diversion due
15 to factors other than price.

16 A Yes, certainly, but you can take differences
17 in quality or performance of a product and evaluate
18 them on a price-adjusted basis very often.

19 Q In the case of the horse and buggy, you
20 can't charge a price that will get people to convert
21 from cars back to horse and buggies, can you?

22 A I don't know. I don't think so today, but
23 suppose the year was 1908. There certainly were some
24 consumers who were marginal consumers at that time.
25 Maybe the milk man delivering milk in a city had a

1 horse and a milk cart, and, at some point, he had to
2 decide whether to replace it with a truck. It's
3 conceivable to me that some of the milk men at that
4 time found trucks too expensive, and they went back to
5 horses.

6 Q Yes, and you wouldn't drop the price. If
7 you were trying to recapture what you lost to the
8 automobile, dropping that price wouldn't necessarily
9 recapture the automobile customer, would it, once they
10 have converted?

11 A No, but there are so many implicit
12 assumptions in your question that it's hard for me to
13 answer it.

14 Q Let's turn to page 14 of your testimony
15 where you talk here about the effects of the Internet
16 on mail, and your example here is the impact on bill-
17 paying customers who now use electronic means to pay
18 the bills.

19 In your example, you show that there are
20 costs besides just postage related to using the mail
21 for paying bills. Is that correct?

22 A That's correct. They are known as
23 "opportunity costs."

24 Q Okay. You show that the total cost,
25 opportunity cost, to pay a first-class bill is \$1.14,

1 which is composed of 39 cents postage plus, I believe,
2 75 cents for the opportunity cost. Right?

3 A The opportunity cost of the person's time,
4 yes.

5 Q Right. Then you show effects on annual
6 costs, assuming 12 bills a month, or 144 bills paid
7 per year. Is that right?

8 A Yes. And I should add that I'm assuming
9 that the 25 cents per minute of the opportunity costs
10 of the person's time is based on an annual salary of
11 \$30,000, which might be lower than a lot of consumers
12 you would be looking at.

13 Q Okay. By the way, aren't there reasons
14 besides just the opportunity cost that people use to
15 pay bills by electronic means?

16 A I don't know.

17 Q You don't know? If you pay a bill
18 electronically, can't you usually specify that the
19 bill actually be charged to your account on the date
20 that it's due?

21 A Yes. In that case, that would be a benefit.
22 It would be a benefit that would also influence this
23 trade-off.

24 Q Right. For example, that would mean that
25 you would, as a bill-paying customer, avoid paying the

1 bill too early, taking it out of your bank account too
2 early, or paying it late and incurring late charges.
3 Is that correct?

4 A Yeah. That's right.

5 Q Now, for a customer who has switched from
6 the mail -- using the mail, of course, you cannot
7 assure that the bill will get there exactly on the
8 date that it's due, can you?

9 A No. My understanding is that the mail is a
10 best-efforts delivery network.

11 Q If someone has already decided that
12 electronic bill paying is so convenient that I'm going
13 to switch because of all of these nonprice factors, if
14 the rate commission reduced the first-class rate by a
15 penny to try to recapture some of that business, how
16 much would that save this bill payer on an annual
17 basis?

18 A The bill payer who has already defected from
19 using the mail?

20 Q A one penny increment; what's the annual
21 cost for that bill payer?

22 A Well, I need to introduce a little bit of
23 terminology here: "marginal consumer" and
24 "inframarginal consumer." The inframarginal consumer
25 is somebody who continues to consume a product even

1 after there is a price change up or down. The
2 marginal consumer is the person who is on the margin,
3 whose consumption decision is affected by those slight
4 price changes.

5 Then I suppose you could define, although
6 you don't usually see this in textbooks, the
7 "extramarginal consumers." Those are the ones who
8 have defected to other products.

9 I think that for purposes of this example
10 and for purposes of your hypothetical, we're talking
11 about -- well, we could talk about all three
12 categories. For the people who have left using first-
13 class mail to pay bills, it's not very likely that
14 they would switch back to using first-class mail. The
15 people who are on the margin; they are the ones who
16 are influenced.

17 Q The ones who have already switched; you
18 can't chase them by reducing the price of postage.

19 A Probably very, very few of them. You're
20 talking about where they are on the demand curve.

21 Q well, for example, in addition to bill
22 payers, let's take another example of diversion away
23 from first-class mail. The Postal Rate Commission,
24 several years ago, adopted electronic filing of
25 documents. Prior to that, our office used to mail out

1 hundreds and hundreds of pieces of mail, and we used
2 to receive some days, a single day, a hundred pieces
3 of mail. We had large Xerox machines that we've since
4 replaced with much smaller ones. We used to hire two
5 paralegals to handle all of the paper flow, both
6 incoming and outgoing.

7 Now, all of that is gone, and we do
8 everything electronically. If the rate commission
9 decided it was going to reduce the first-class postage
10 rate, do you think that would cause the rate
11 commission to decide, well, let's go back to paper
12 filing and abandon electronic?

13 A No, I don't.

14 Q And that's because there are huge advantages
15 of electronic filing compared to mailing that have
16 nothing to do with postage. Is that right?

17 A That's true, and the point of my example
18 here with the bill paying is to show that the price of
19 first-class postage is only one input among perhaps a
20 number. In this case, it's the person's time to write
21 a check, put the check in the envelope, mail it, and
22 so forth.

23 In your office example, yes, there are other
24 costs associated with the physical movement of paper
25 as opposed to the electronic movement of paper.

1 Q And there are even some other values, such
2 as, for example, when you do the electronic filing, we
3 used to have to maintain bookshelves filled with
4 three-ring binders of original hard-copy documents,
5 and now we rely entirely on the rate commission's Web
6 site for all of our document management, pulling down
7 just those that we want when we need them. Is that,
8 likewise, another benefit, nonpostal rate benefit, of
9 going to electronic communications? It has nothing to
10 do with the postage rate that we paid.

11 A Yes. Of course, there are offsetting
12 considerations, too. Your server might crash. It's
13 an overall calculation you're making.

14 Q I have downloaded the important documents
15 onto my computer.

16 Those are both sort of ways of saying that
17 nonprice factors can be far more important than price
18 when it comes to postal products. Is that correct?

19 A Not really. What I'm getting at here is
20 that there is a price of all of these other inputs.
21 There is a price of a person's time. In your example,
22 there is the wage that you have to pay the paralegals
23 for handling the flow of paper, or that you had to pay
24 in the past, I should say.

25 So you can identify what the cost of all of

1 these other inputs is. So, in that sense, I don't
2 think that the point is that you can't measure either
3 the value or the cost of other inputs that are being
4 used or other benefits that are being generated. I
5 think it still lends itself to some form of
6 measurement, and we measure things using dollars.

7 Q I understand that you can measure, for
8 example, price sensitivities.

9 A That's not what I was getting at. Not price
10 sensitivity of mail; I'm talking about the demand for
11 all of the other inputs associated with performing a
12 particular task, whether it's writing a check and
13 paying my electric bill or filing something at the
14 Postal Rate Commission.

15 Q When it comes to deciding what to charge for
16 postal rates, though, don't you have to take into
17 account whether or not a change in the postal rate is
18 going to induce either customers who have already
19 switched to electronics to come back to the mail or
20 those at the margin to switch over?

21 A I think that the real question that faces
22 the Postal Rate Commission in that setting is to ask,
23 are we talking about movements along the demand curve,
24 or are we talking about a shift of the demand curve in
25 or out? In my view, you're seeing a dramatic shift of

1 the demand curve for first-class, single-piece mail
2 inward, and that's fundamentally different from a
3 movement along the demand curve.

4 Let me give you an analogous situation that
5 I've studied in telecommunications. Virtually
6 everybody would sign up for a discount calling plan
7 for long distance service, but the long distance
8 carriers would still have a basic calling plan which
9 had the very high rates. Some people were continuing
10 to pay the basic rates.

11 I've studied this issue with an economist,
12 and we found that it tended to be older people, for
13 example, who might not be as aware of options that
14 were out there for cheaper calling; less educated
15 people.

16 So what happens is you end up with a smaller
17 and smaller pool of consumers who are continuing to
18 purchase the service, and I think that there were some
19 questions earlier today about fairness, and I think
20 this is an interesting way of looking at fairness.
21 When the demand curve is shifting inward, and the
22 consumers who continue to serve the product are being
23 asked to pay higher prices because of common cost
24 contribution or the like, at what point does that seem
25 to be contrary to some idea of fair and equitable

1 rates?

2 Q Well, are you suggesting that first-class
3 rates ought to be frozen, that it's unfair to increase
4 first-class rates?

5 A That's a possibility.

6 Q That first-class rates should be frozen?
7 Would freezing first-class rates cause any appreciable
8 volume of people who have already left the system to
9 come back?

10 A You're changing the subject. I'm talking
11 about the people who continue to purchase --

12 Q I understand you are. Would you answer my
13 question?

14 A Yes. I don't think you would get a lot of
15 consumers coming back and using the mail, for the
16 reasons we've been talking about, that there are lots
17 of other inputs that go into tasks that involve using
18 postage, but that doesn't affect the decisions of the
19 inframarginal consumers, and those are people that
20 ought to be protected by the postal statute, too.

21 Q The Postal Service doesn't really truly have
22 a monopoly on first-class mail in the sense that there
23 is a very large and viable, nonhard-copy alternative.
24 Isn't that true?

25 A In my opinion, the statutory monopoly over

1 first-class mail does not prevent consumers from
2 switching to other communication technologies. What
3 it does is it prevents entry into the delivery of mail
4 to the remaining inframarginal consumers. So, in that
5 sense, you're tightening the screws. You're finding
6 out who are the people who are the least likely to
7 shift to a cheaper alternative.

8 Q So you're suggesting that if you have a
9 large diversion of bill payments into electronic means
10 fewer and fewer bill payers using hard copy. Isn't
11 there a point at which there would not be a market for
12 hard copy delivery outside the Postal Service?

13 A That's quite possible. I'm sorry. Could
14 you repeat the question? When you say "hard copy
15 delivery outside the Postal Service," do you mean by
16 private companies?

17 Q Yes.

18 A My understanding is that that would violate
19 the --

20 Q I'm saying if they were allowed to do that,
21 if you're allowed to pay bills, through hard-copy
22 means outside the Postal Service.

23 A Yes. I think it's quite possible that there
24 would not be sufficient demand for private delivery of
25 first-class, single-piece letter mail.

1 Q So that really means that if you looked at
2 the monopoly, it might not have that much impact
3 anyway.

4 A I think that's quite possible.

5 Q Turn to page 22, please. Starting at line
6 15, this is where you start talking about shifting of
7 the institutional cost burden away from first class
8 and toward standard commercial. Do you see that?

9 A Could I have a second to read it?

10 (Pause.)

11 THE WITNESS: Okay. Did you want me to read
12 past the bottom of 22?

13 MR. McLAUGHLIN: You can, if you wish.

14 (Pause.)

15 THE WITNESS: Okay. I've looked at it.

16 BY MR. McLAUGHLIN:

17 Q In your first sentence, you're talking about
18 ECR cost coverage, and this is in relation to Witness
19 Mitchell's proposal to reduce that cost coverage.

20 In the second sentence, you then talk about
21 how you believe it would be wiser to go in the other
22 direction, but there you talk about increasing the
23 cost contribution for standard commercial mail. Is
24 there a reason why you switched from ECRs to standard
25 commercial in that second sentence? In the first

1 sentence, you talk about ECR; in the second sentence,
2 you talk about standard commercial. Standard
3 commercial consists of ECR plus regular subclass.
4 Right?

5 A Right. I think the point that I'm making
6 here is the inward-shifting demand curve for first-
7 class mail. I don't think that I'm trying to draw a
8 fine distinction between standard regular and standard
9 ECR.

10 Q Well, they are subclasses that have
11 different characteristics, don't they?

12 A I haven't studied the different
13 characteristics that they might have, but I think that
14 what is relevant for purposes of my testimony is that
15 it's not likely that the demand for either of those
16 classes of standard commercial mail will experience
17 the same kind of drying up that I think will happen
18 with respect to first-class mail, single-piece,
19 particularly.

20 Q Of those two subclasses, ECR and standard
21 regular, do you have any view as to which might be at
22 somewhat greater risk of those two?

23 A Can you be a little more specific? Greater
24 risk from what?

25 Q Well, from drying up if you start piling on

1 additional institutional cost contribution onto their
2 rates.

3 A I think we have to back up. When I referred
4 to drying up, I was alluding to electronic
5 substitution. I thought you were asking a different
6 question. I thought you were asking me which of the
7 two classes of standard mail is more vulnerable to
8 electronic substitution, but now I'm confused as to
9 what your question is because now I think you're
10 asking me a question about prices.

11 Q Your paragraph here dealt with shifting
12 institutional cost contribution onto standard
13 commercial mail.

14 A Right.

15 Q I was asking you, as between the two
16 subclasses within that category, which would be at
17 greater risk from an increased institutional cost
18 contribution?

19 A I would have to have price elasticities in
20 front of me for ECR and for regular to begin to answer
21 that question, and I haven't tried to answer it in my
22 testimony.

23 Q So you're not familiar with that, and you
24 didn't address it in your testimony. Is that correct?

25 A Yes. Let me go back and say what I said

1 earlier. My testimony is focusing on the forest
2 rather than the trees. What are the large trends that
3 are in electronic communications, particularly
4 broadband, that are influencing the demand for various
5 classes of mail?

6 Q Okay.

7 A So I'm not trying to replicate some sort of
8 rate calculation in my testimony.

9 Q Now, stay on page 22. Basically somewhere
10 around -- I think it's the sentence starting on line
11 18, you talk about it seems wiser to increase the
12 institutional cost contribution borne by standard
13 commercial mail rather than risk further substitution
14 away from first-class mail and toward electronic
15 communications. Do you see that?

16 A Yes.

17 Q Are you suggesting there that to avoid the
18 risk of further substitution toward electronic mail,
19 electronic communications, that it's necessary to
20 reduce the first-class contribution?

21 A I think it's useful to look at my testimony
22 in this way. I'm looking at general trends and
23 relationships between demands for different classes of
24 mail, and I'm not attempting to give you a point
25 estimate as to when first-class mail will disappear or

1 whether one particular level of cost coverage has some
2 magic value.

3 What I'm getting at is the general direction
4 of change in the demand for these different classes of
5 mail and their ability to support cost recovery. If
6 the volume of first-class pieces is declining, it just
7 doesn't have the same ability to support a given
8 amount of common cost recovery.

9 Q Okay. So, in other words, at this point,
10 you're now talking about total dollars of
11 contribution, that maintaining total dollars of
12 contribution was your concern.

13 A Yes. I'm concerned about that, but I'm a
14 concerned about the relative contributions that these
15 classes are making.

16 Q What confuses me is that you just suggested
17 earlier that freezing the price of first-class mail
18 might make sense.

19 A It might. It might. There are many
20 regulated industries where the price is not permitted
21 to rise, where it has to go down over time. That's
22 price cap regulation in telecommunications.

23 Q And what would that do to contribution from
24 first-class mail? That would not stem the loss of
25 contribution in any appreciable way from electronic

1 diversion, would it?

2 A Probably not, but that's not why you would
3 do it.

4 Q You would do it for fairness considerations.
5 Is that what you're saying?

6 A Well, you can call it fairness, but also
7 economists who look at pricing problems for
8 multiproduct firms are familiar with the solutions
9 that are likely to produce higher levels of consumer
10 welfare rather than others.

11 Q Now, if the subclass that you shift this
12 increased contribution to happens to be a price-
13 sensitive subclass, and let's assume that ECR is a
14 price-sensitive subclass and that mailers within ECR
15 compete with members of your client, and that's part
16 of the reason for the price sensitivity, what would
17 that do to ECR volumes?

18 A Well, if the price of ECR rises relative to
19 substitutes, its demand will fall, but you have to
20 look at relative prices. Absolute prices, by
21 themselves, are not that informative because people
22 make decisions on the margin.

23 MR. McLAUGHLIN: I have no further
24 questions.

25 CHAIRMAN OMAS: Thank you, Mr. McLaughlin.

1 The Alliance of Nonprofit Mailers and
2 Magazine Publishers of America, Mr. Levy.

3 MR. BAKER: Mr. Levy informed me by e-mail
4 that he was not going to have oral cross today.

5 CHAIRMAN OMAS: Thank you, Mr. Baker.

6 The United States Postal Service, Ms.
7 McKenzie. Mr. Koetting. I'm sorry.

8 MR. KOETTING: No problem, Mr. Chairman.
9 Thank you.

10 CROSS-EXAMINATION

11 BY MR. KOETTING:

12 Q Good afternoon, Mr. Sidak. My name is Eric
13 Koetting, and I'll be asking you some questions on
14 behalf of the Postal Service.

15 Mr. McLaughlin happened to touch on a lot of
16 the same topics, so I'm going to try to cut through
17 some and see if we can work through this a little more
18 quickly, but I will be visiting a lot of the same
19 topics, I think.

20 You were speaking with him about your
21 example that's on page 14 and then sort of expanded
22 that conversation to a more general notion of the
23 types of considerations that people pay attention to
24 when they are deciding whether to pay bills by mail.

25 I think it's fair to say, and correct me if

1 you disagree, that ultimately one of the things that
2 came out of that discussion was that people focus on
3 both the cost of a particular type of transaction and
4 the benefits, and they compare those two, and they are
5 looking for the highest net benefit. Correct?

6 A Yes.

7 Q You talk about higher net benefits on page
8 14 with respect to that particular example.

9 I notice, on page 2 of your testimony, you
10 mention that you co-authored a book with Professor
11 Daniel Spulber of Northwestern University. Correct?

12 A I have written two books with him.

13 Q Two books. Good. Are you aware that
14 Professor Spulber presented testimony to the
15 Commission on exactly the topic of the relative cost
16 and benefits relevant to the choice of electronic
17 transaction versus mail 12 years ago?

18 A No. I didn't know that.

19 Q That was, specifically, in Docket No. R94-1.
20 In September of 1994, he presented rebuttal testimony
21 on behalf of AAMA, MASA, DMA, and MOM.

22 A I'm sorry. Could you give me that list that
23 was an alphabet soup there?

24 Q Sure. It was rebuttal testimony in Docket
25 No. R94 on behalf of **AAMA, MASA, DMA**, and MOM, and

1 that testimony was far too lengthy for me to try to go
2 through all of it, but a lot of what he did was
3 compare his assessment of the benefits and the costs
4 of various specific applications, such as billing and
5 messaging and data interchange and document
6 processing.

7 I thought, at the very least, it might be
8 interesting, given the fact that his background, I
9 take it, is somewhat similar to yours, in fact, that
10 you're both telecommunications experts, as to how you
11 might view the conclusions that he drew, recognizing
12 that these were made in 1994, which was at a different
13 stage than we are in this transformation to the
14 electronic highway or wherever we're going.

15 A Well, I don't have the benefit of reading
16 his testimony, so I'm limited in what I can say.

17 Q Right. Well, if you prefer, I'll give you a
18 copy of his entire testimony, if that will make it
19 easier, but I only have a couple of things. I have a
20 copy for you, and I have a copy for your counsel.

21 A Okay. Thank you.

22 Q I just want to look at the very big picture
23 items. You basically spoke, I think, about preferring
24 to look at the forest rather than the trees, and I
25 think we can keep it at that level.

1 A Right.

2 Q On page 12 of his testimony, Professor
3 Spulber drew the following general conclusions. He
4 said, "Technological and market changes are increasing
5 the benefits and reducing the cost of electronic
6 transmission. These factors are responsible for the
7 rapid expansion of electronic transmission."

8 Do those statements seem to still be on the
9 mark to you today?

10 A I would like to have a little bit better
11 sense of whether he is defining "electronic
12 transmission" in any specific way. Is he? Do you
13 know?

14 Q I don't recall that there is any ..

15 A Is that being used to define some
16 subcategory of electronic communication?

17 Q I think he was simply talking about the
18 various forms of electronic communication that were
19 available in 1994.

20 A All right. I see on page 4 that he is
21 listing fax, e-mail, EDI, and electronic funds
22 transfer.

23 Q Right.

24 A Well, I would agree with the statement on
25 page 12, that technological and market changes are

1 increasing the benefits and reducing the costs of
2 electronic transmission. It seems to me that's pretty
3 hard to dispute. "These factors are responsible for
4 the rapid expansion of electronic transmission." That
5 seems pretty uncontroversial.

6 Q Well, let's look at what he continues to
7 say, then, on page 12, and this may sound very
8 familiar, given your discussion with Mr. McLaughlin,
9 and for the benefit of those who don't have the
10 testimony, I'll read the two sentences I'm referring
11 to.

12 "These ongoing and fundamental changes are
13 entirely independent of postal rates. They can no
14 more be diverted or slowed by a change in postal rates
15 than a reduction in the cost of feeding horses would
16 have halted the development of the automobile."

17 Once again, 12 years down the road, do you
18 have any reason to disagree with the general thrust of
19 those statements?

20 A No. I think that what Professor Spulber is
21 getting at is the same point that I was getting at,
22 that what consumers, including businesses, care about
23 is achieving some particular task, performing some
24 function, and one way of doing that may involve
25 purchasing postage, and another way might not. But

1 there might be other inputs that go into sending a
2 payment from San Francisco to New York, for example.
3 There is people's time, and it's not simply dropping a
4 check in the mail versus doing an electronic funds
5 transfer.

6 Q I would like to turn to page 15 of your
7 testimony, and I think we're more or less done with
8 Professor Spulber because there don't seem to be any
9 major points of difference that are worth exploring at
10 the moment.

11 A I'm sorry. Did you say page 15?

12 Q Page 15 of your testimony, starting on line
13 5. Do you see your statement that "when consumers
14 defect from first-class mail to electronic forms of
15 communication, the customers who remain are the
16 inframarginal users of first-class mail who have fewer
17 competitive alternatives"?

18 A Yes, I see that.

19 MR. KOETTING: I would like to compare that
20 statement of yours with one made by Postal Service
21 Witness Thress. This was in his response to
22 Interrogatory 8(e) from the Greeting Card Association,
23 and to make it easier, I'll go ahead and hand out
24 copies of it.

25 (Pause.)

1 MR. BAKER: Mr. Koetting, do you have the
2 question that this is the answer to?

3 MR. KOETTING: I do not. It was a multipart
4 question that went on for pages and pages. I really
5 only want to focus on one sentence, actually part of
6 one sentence.

7 THE WITNESS: Could you give me a minute to
8 read? I'm a very slow reader.

9 MR. KOETTING: Sure.

10 (Pause)

11 THE WITNESS: Okay. Thank you.

12 BY MR. KOETTING:

13 Q Just so we're all back on the same page, I
14 think I'll go ahead, and I will read the sentence of
15 his that I'm most interested in, and then I'll go back
16 and re-read your sentence, and then we can compare, if
17 you don't mind.

18 The sentence of his -- it's actually even
19 the partial sentence of his -- that I would like to
20 focus on is the statement in the bottom part of the
21 page where he says, "For example, the introduction of
22 a new product may induce more price-elastic consumers
23 to stop using the old product, leaving the average own
24 price elasticity of the product's remaining customers
25 lower than before the introduction of the new

1 product."

2 And, again, the sentence of yours that I
3 want to compare that with is the one that reads:
4 "When consumers defect from first-class mail to
5 electronic forms of communication, the customers who
6 remain are the inframarginal users of first-class mail
7 who have fewer competitive alternatives."

8 Comparing those two statements, would you
9 agree that, with the mutual focus on the remaining
10 customers, you and Witness Thress are essentially
11 following the same logic, which is, if new electronic
12 alternatives have, if you will, skimmed off what I
13 suppose you would refer to as the "marginal users,"
14 then it is the price sensitivity of the inframarginal
15 users who are left behind which is relevant as we move
16 forward? Would you agree with that?

17 A Yes, but I would like you to explain to me
18 what you mean by "relevant as we move forward."
19 Relevant for what purpose?

20 Q Well, relevant in terms of what the effects
21 will be of changing the price on mail volume.

22 A Okay. Not, for example, the effect on the
23 welfare of the remaining consumers.

24 Q No. We'll get to that. And so because, as
25 you say, they have fewer competitive alternatives, the

1 price sensitivity of the remaining users would not
2 necessarily be higher, and maybe could even be lower,
3 than the overall price sensitivity we started with
4 before the emergence of the electronic alternatives.
5 Correct?

6 A I'm sorry. I missed where you're reading.

7 Q I'm not reading. That's a question.

8 A Okay, then. Could you repeat it?

9 Q Sure. Well, I did read something in there.
10 What I read was, pulling your final phrase of fewer
11 competitive alternatives as part of my question. What
12 I'm saying is, because, as you say, these remaining
13 customers have fewer competitive alternatives, the
14 price sensitivity of the remaining users would not
15 necessarily be higher, and perhaps could even be
16 lower, than the overall price sensitivity we started
17 with before the emergence of the electronic
18 alternatives. Does that seem reasonable?

19 A Yes. I think that's possible.

20 There is one thing I would like to clarify
21 about that sentence from page 15 of my testimony that
22 you were reading. I say that the customers who remain
23 are the inframarginal users of first-class mail who
24 have fewer competitive alternatives. I probably
25 should have added that they have fewer competitive

1 alternatives, and/or they may have higher switching
2 costs. They may not be as informed about
3 alternatives.

4 Getting back to the analogy that I mentioned
5 earlier about long distance telephone customers, I
6 suspect that the people who remained on the high-cost
7 calling plans just were not as aware of the
8 alternatives available to them.

9 Q Okay. We can, I think, segue into maybe
10 where you wanted to go earlier. You called it
11 "welfare fairness," that aspect of it. Isn't it also
12 possible simply that we have people who value mail
13 more, and to put that in very concrete terms, people
14 who have PCs, have Internet connections, have the
15 ability to pay their bills online, but they have
16 concerns about security, or they have concerns about
17 reliability?

18 For whatever purpose, they value putting
19 that check in the mailbox and assuming that it's paid,
20 and they don't value the alternative that way, and,
21 therefore, their decision to choose mail reflects a
22 higher value to them of mail rather than an inability,
23 their inability to access the alternative.

24 A That's a long question, **so** let me take it in
25 pieces. Yes, it is possible that there are consumers

1 who don't trust making a payment over the Internet,
2 and so that might be a reason that they want to
3 continue posting their checks.

4 I wouldn't leap to the conclusion though
5 that people who use the mail do so simply because they
6 don't like using the Internet. We do not have 100
7 percent broadband coverage in the country. The price
8 of broadband is coming down, but it still may be
9 higher than what some people can afford.

10 I think there's also another interesting --
11 it's a kind of reality check on your point about the
12 value that these consumers place on being able to mail
13 a letter. Implicit in your assumption there is that
14 they have a higher willingness to pay.

15 Well, they can always move up to the next
16 level of service, depending on whether they're willing
17 to pay enough, for example, to send an overnight
18 letter that includes something better than best
19 efforts delivery and may require a signature or
20 something like that.

21 So it's not necessarily clear to me that the
22 higher value that those remaining consumers place on
23 first class mail means that they continue to use first
24 class. They may migrate to a more expensive class of
25 mail that offers a different kind of level of service quality.

1 Q So, for example, not to get too personal
2 here, but for somebody or a member of their household
3 who neglected to mail a bill over the Thanksgiving
4 holiday may have found themselves at the Post Office
5 on Monday morning sending it express mail is perhaps
6 what you're suggesting?

7 A Yes.

8 Q It did deliver. I checked on the Web,
9 however, and it got there on time. I'm happy to
10 report, on time performed.

11 (Laughter)

12 BY MR. KOETTING:

13 Q Nevertheless, wouldn't you agree that the
14 vast majority of American bill payers rely on first
15 class mail to pay their bills, and they don't buy up
16 either to priority mail or express mail?

17 A I'm not sure about that. Are you talking
18 about the customers who have not defected to
19 electronic payment; or are you saying, of those who
20 continue to use some Postal service?

21 Q Correct.

22 A I don't know. I haven't seen data on that.
23 But it seems plausible to me that there are more of
24 those customers using a regular 39 cent stamp than
25 moving up to priority mail or overnight.

1 Q The point that I was trying to make is that
2 there is a value component to people's choice, as well
3 as a willingness to pay. I'm certainly not
4 disagreeing with you that it would be very difficult
5 to disentangle the two.

6 A Economists equate them. The willingness to
7 pay is how we measure value.

8 Q And economists would suggest that it's
9 perfectly reasonable to charge more to people who
10 value a product more than for another product that
11 people don't value as much, correct?

12 A Economists would; but regulators often don't
13 like that.

14 Q Oh.

15 A That's why we see reverse Ramsey pricing in
16 practice by the industries.

17 Q In the Postal Reorganization Act, it
18 specifically refers to value of service as one of the
19 factors that the Rate Commission is required to
20 consider. I'm assuming you're aware of that?

21 A Yes.

22 Q And normally, that has been equated in the
23 Rate Commission with a higher value of service
24 justifies a higher cost?

25 A But your question raises a very interesting

1 point that I've never seen addressed. That is, value
2 of service to whom; which consumers; which purchasers
3 of mail services -- value to the people who left first
4 class mail? Are we only looking at the willingness to
5 pay of the people who stick around; or do we also look
6 at the willingness to pay of people who got up and
7 left?

8 It seems to me that Congress wrote a statute
9 that applies to all Americans; not just people who
10 remain captive Postal customers.

11 Q Well, if you can figure out how we can get
12 money out of the people who aren't mailing, I'm sure
13 that we would all be most interested in hearing your
14 suggestion.

15 A Well, my advice is not that you try to take
16 it out of the hide of the people who continue to use
17 first class mail, because they'll get up and leave,
18 too, eventually. You're looking at a reservoir that
19 is evaporating.

20 Q Well, let's examine that a bit. You just
21 used the expression, "take it out of the hide of."
22 Earlier, you used the expression, I believe, "tighten
23 the screws." That was another expression that you
24 used.

25 Would you agree that over the last decade or

1 several decades that the price of first class mail in
2 real terms has been essentially flat?

3 A I haven't tried to generate a series of real
4 prices for first class mail. I mean, there's been
5 more than a ten-fold increase in the price of a stamp
6 since, what, about 1960? When did the three cent
7 stamp disappear?

8 Q I actually have something that I can show to
9 you.

10 A Okay -- I like to give pop quizzes, too.

11 (Laughter)

12 BY MR. KOETTING:

13 Q For the record, this is simply a page from
14 the testimony of Postal Service witness Bernstein in
15 this case, **USPS-T-8**; and on page seven, he has a chart
16 two, which shows the real price of first class mail.

17 Professor Sidak, having had a chance to look
18 at this, would you agree with my earlier
19 characterization that over the last several decades,
20 the price of first class mail has been essentially
21 fairly constant?

22 A Yes, subject to Mr. Baker's advice, I've
23 made a modification of the chart that might be useful
24 to be included in the record, as well. I've drawn
25 another line on the chart that will shed some

1 additional light on what you've shown me here.

2 It's a line showing the cost of long
3 distance telephone service in real terms over the same
4 period of time, which is a declining asymptotic line
5 curve, okay?

6 So it may be true that the price of first
7 class mail has remained constant from 1972 to 2005.
8 But the real cost of a three minute long distance
9 telephone call has gone down in real terms far more.

10 Q Well, I mean, I think that's an interesting
11 observation. But there isn't a whole lot that the
12 Postal Service or the Postal Rate Commission can do
13 about that in terms of trying to match through Postal
14 rates the changes in telecommunication costs driven by
15 changes in telecommunication technology.

16 A People stop writing letters, and making long
17 distance phone calls instead, a long time ago. So
18 we've been talking about inframarginal versus marginal
19 consumers of first class mail, and how that might be
20 influenced by the Internet. But it happened before,
21 with respect to long distance telephone calls.

22 It's not just voice traffic. It was fax
23 traffic, first. Nobody sends faxes any more because
24 it's easier to send e-mail attachments. But there was
25 a point, not that many years ago, where data traffic

1 crossed over and exceeded the amount of voice traffic.

2 Q Okay.

3 A And presumably, the data traffic is
4 something that ends up being represented ultimately in
5 some kind of printed form; something that could have
6 gone in the mail. So, in essence, it is displacement.

7 So the important question to ask, as you
8 look at chart two and then you consider what happened
9 to the real price of long distance telephone calls and
10 faxes is, how did the relative price of these two
11 methods of communications change over time; and the
12 relative price changed a lot. It's much cheaper now,
13 in relative terms, to communicate electronically than
14 it was 30 years ago.

15 Q Right, and I believe that what you just
16 indicated corroborates the testimony of Witness Thress
17 in this case, which is that the diversion of former
18 Postal volumes into electronic communication hasn't
19 been a function of Postal price, which has been
20 relatively flat over the period in which its volume
21 has gone away. It's been a function of the fact that
22 the cost of the electronic alternatives has gone down
23 so dramatically.

24 A Well, I don't agree with that statement.
25 There are probably a number of reasons why the demand

1 for first class mail is what it is and has been what
2 it has been over time. But the relative price between
3 first class mail and the next available electronic
4 alternatives is very important to the overall level of
5 first class mail that's consumed.

6 Q That's correct, and perhaps you were
7 reacting to the first part of my statement and weren't
8 focusing on the second part.

9 Witness Thress was saying that the decline,
10 if you examine the real price of first class mail, it
11 has remained essentially constant. The
12 telecommunication price, or electronic communication,
13 has gone down so dramatically. Therefore, as you were
14 suggesting, in terms of the relative price of those
15 two, that's causing the transformation. But it's not
16 because of an increase in Postal rates, which have
17 remained constant in real terms. It's because of the
18 decline in real terms of the substitutes.

19 A Yes, but what I was saying is that the
20 relative price has changed. So you have a numerator
21 and denominator, and the relative price can change.
22 Because one changes, the other changes or both of them
23 change. It seems to me that what you're saying is,
24 one of them has remained constant and the other has
25 gone down.

1 Q Well, generally speaking, we know what the
2 price is for Postal products, and we can deflate that
3 using a generally-accepted deflator.

4 A Right, right.

5 Q We've had a heck of a time trying to
6 identify what the price to use as the price of these
7 substitutes, in terms of what you're calling the
8 relative price.

9 A Okay, I think I see we're talking past one
10 another here. You were talking about the demand for
11 first class mail not being affected. It's not going
12 down because the price of first class mail is staying
13 constant over time.

14 My point is, you're focusing on the wrong
15 price. What you should look at is the relative price
16 of first class mail to an electronic substitute that's
17 readily available. In that sense, even if the cost of
18 a first class stamp has remained constant over time,
19 you could still have massive defection away from first
20 class mail, because the relative price has
21 dramatically changed.

22 Q All right, which brings us back to Professor
23 Spalburr's statement 12 years ago, that these
24 developments are essentially independent of Postal
25 rates, because the increase in the benefits and the

1 decrease in the costs of these electronic alternatives
2 just overwhelm any potential adjustments that could be
3 made on the Postal side of the demand equation. You
4 would agree with that? You're nodding your head,
5 that's why I'm asking.

6 A I think I agree with it. But if you want to
7 continue this line of questioning, I'm happy to add
8 more complications.

9 Q I think we're done. Thank you very much;
10 I've appreciated the conversation; thank you.

11 A Thank you.

12 (Witness excused.)

13 CHAIRMAN OMAS: Thank you, Mr. Koetting; Mr.
14 Olson?

15 CROSS EXAMINATION

16 BY MR. OLSON:

17 Q Professor Sidek, Bill Olson representing
18 Valpak -- I'd like to follow-up, I guess, on some of
19 Mr. McLaughlin's testimony; just to have you focus
20 first on page three, lines six and seven, where you
21 identify what your testimony is about, Line six, if I
22 could just read you, "Contrary to their testimony" --

23 A I'm sorry, what page is this?

24 Q Page three, line six.

25 A Thank you.

1 Q "Contrary to their testimony, there is
2 reason to believe that the institutional cost
3 contributions of standard ECR should be higher, rather
4 than lower, as they contend." Do you see that?

5 A Yes.

6 Q Then you say, you refer to this reason to
7 believe, in the next sentence, as a conclusion,
8 apparently. Is that what you're referring to in the
9 conclusion, when you say, "this conclusion"?

10 A Yes.

11 Q Okay, then on page four, line 22, at the end
12 of the page you say, "I conclude the Commission should
13 reject proposals to reduce the institutional costs
14 assigned to standard enhanced carrier route mail,"
15 correct?

16 A Yes.

17 Q Lastly, on page eight, lines five to seven,
18 you say, "Standard mail ... is the candidate with the
19 most volume over which these institutional costs
20 should be recovered," correct?

21 A Yes.

22 Q Now at this point, are you alleging that
23 Witness Mitchell is proposing to reduce the coverage
24 of all standard mail?

25 A My understanding is that he would reduce the

1 rate for standard ECR, and increase the rate for
2 standard regular; and that that would be justified on
3 the grounds of shifting more overhead costs, more
4 institutional costs to standard regular.

5 Q Right, and what I'm trying to get at is that
6 sometimes in your testimony, as Mr. McLaughlin went
7 over, you refer to standard regular and sometimes to
8 standard ECR. But you did say that you had not
9 studied the different characteristics of standard
10 regular and standard ECR. Did you not say that
11 before?

12 A No, I haven't examined them in great depth,
13 no.

14 Q So your testimony doesn't speak to whether,
15 in your opinion, for example, the coverage of standard
16 regular is too high or too low; or the coverage of
17 standard ECR is too high or too low, relative to the
18 other class within standard.

19 A Yes, I agree. That's not really the thrust
20 of my testimony.

21 Q Your testimony more has to do with standard
22 versus first class, for example.

23 A Yes, yes.

24 Q Okay, so in that sense, your rebuttal
25 testimony doesn't go to the heart of that central

1 issue in Witness Mitchell's testimony, as to whether
2 relatively standard ECR or standard regular are in the
3 wrong position and should be moved. If you haven't
4 studied ECR and regular, I doubt if you're in a
5 position to speak to --

6 A The reason I pause in answering is that Mr.
7 Mitchell relies heavily, as I read his testimony, is
8 Witness Thress' elasticity estimates of ECR and
9 standard regular; and Dr. Ingram, my colleague, is
10 going to be addressing the econometric work with
11 respect to that question when he's cross examined on
12 his rebuttal testimony. So I don't want to get into
13 that.

14 But to the extent that the elasticity
15 estimates from Mr. Thress are used, then there may be
16 some question as to whether the elasticity estimates
17 have been correctly done in the first place.

18 Q Okay, I understand that.

19 A And that relates to the electronic
20 substitution issues.

21 A I understand that if Witness Mitchell relied
22 on Witness Thress' elasticities and if it's
23 demonstrated that those are wrong, that's a different
24 issue.

25 Q Yes.

1 A But again, that's the only sense in which
2 you comment on the relative cost coverage burden that
3 standard regular and standard ECR should share,
4 correct?

5 A I think that's fine.

6 Q Okay, let's get to the tectonic changes.
7 Well, let me step back. You have been at the American
8 Enterprise Institute on and off, I guess, for some
9 time.

10 A I was there for 13 years. But I'm at
11 Georgetown now.

12 Q Right, and you've been a student of the
13 Postal Service for some time, and probably have read a
14 bit of Postal history.

15 Let me ask you, in that time, are you aware
16 of a prediction that was made in the middle of the
17 19th century, when the story goes that the Postmaster
18 General put in his annual report to Congress that the
19 telegraph and its instantaneous ability to allow
20 communication across long distances would cause first
21 class volume to decline? Do you recall that?

22 A I don't.

23 Q You haven't read that one? Are you aware
24 that in the early 20th century, that the Postal
25 Service predicted that access to the telephone would

1 cause a decline in first class mail?

2 A No, I'm not aware of that. I am aware that
3 at the time of the break-up of the Bell system, right
4 at the time of the break-up, the consulting firm,
5 McKinsey, was hired to advise AT&T on how the assets
6 of the Bell system should be divided between the
7 company that retained the name AT&T and the various
8 operating companies.

9 One of the assets was cellular licenses.
10 McKinsey did a study and told AT&T that there might be
11 a million cellular subscribers in the U.S. one day.

12 Q Professor Sidak, I'm sure this is a great
13 story. But just in the concession in the mortality of
14 man, I want to get on with what I want to cover.

15 A My point is, it's a long-winded way of
16 saying, there are examples of wildly erroneous
17 predictions on both sides.

18 Q Right and, in fact, there were people who
19 predicted the fax machine would destroy first class
20 mail; were there not; probably, in any rate?

21 A There may be, yes.

22 Q To the extent that there were earlier
23 prophets of that sort that forecast the death of first
24 class mail due to technological change, it would be
25 fair to say that Mark Twain was right and that their

1 predictions might have been a bit premature, anyway?

2 A You have to consider what the counter
3 factual would be. What would the demand be, in the
4 absence of new technology?

5 Q Yes, I'm not talking about the absolute
6 level of first class mail; but simply the prophecy of
7 doom.

8 A The prophecy of doom would be exaggerated.
9 But as I say, the volume of first class mail would
10 have been higher in the absence of the new substitute.

11 Q Sure, I'm sure everybody agrees with that.

12 A Substantially higher.

13 Q Let's talk about Witness Thress that you
14 mentioned. You cite Witness Thress, pages nine,
15 sixteen, seventeen, eighteen, nineteen. There's no
16 sense in going over them. I just want to get the core
17 point. I think that's on page seventeen. Let's see
18 if we can find that.

19 Yes, here's where you say -- this is line
20 twelve -- "It is unlikely that Witness Thress has
21 adequately measured the most important of the recent
22 effects of and trends in electronic diversion of first
23 class mail." That's where that statement appears,
24 correct?

25 A Yes.

1 Q So is it your opinion, in this testimony,
2 that Witness Thress' volume forecast for first class
3 mail is way wide of the mark?

4 A Yes, see, this is an example of my attempt
5 to give some kind of qualitative reality check on what
6 Witness Thress did econometricly. I'm approaching
7 this from somebody who works in the telcom industry a
8 lot.

9 Q Right, but you're criticizing Witness
10 Thress' estimates of elasticity for volume projections
11 for first class mail, saying they're overly
12 optimistic.

13 A I think he's under-estimating the amount of
14 diversion, right.

15 Q So it would be fair to say that if, for
16 example, the Commission, in evaluating these
17 forecasts, were to decide that Witness Thress'
18 estimates of the diversion and first class volume was
19 more accurate than those who have criticized that
20 position, then your criticism of Witness Mitchell on
21 his analysis would tend to fall, correct?

22 I mean, if you're right about the
23 elasticities and the Commission accepts that, then
24 that would be an argument against Witness Mitchell.
25 If the Commission doesn't accept that, then that

1 argument would fall, correct?

2 A I'm confused by your question, because my
3 understanding of Witness Mitchell is that he is
4 relying on elasticity estimates for standard ECR and
5 standard regular. Whereas, the point I was making
6 here on page seventeen is --

7 Q First class.

8 A -- yes, first class.

9 Q No, I understand. But isn't your criticism
10 more broad than that? Let me ask you that question.
11 Are you criticizing Witness Tress' standard mail
12 volume estimates?

13 A I wasn't really focusing on them, because I
14 was more interested in this question of what's
15 happening to first class.

16 Q Okay, so at this point, your testimony,
17 you're talking about Witness Thress' first class
18 volume estimates and his under-stating the division,
19 page seventeen. That's what your testimony is about.
20 I don't want you to go beyond your testimony. I want
21 you to tell me what your testimony covers now.

22 A Well, I think it says that in black and
23 white on seventeen, line fourteen.

24 Q Then I'll accept that. That's all I needed.
25 Page five, if we could, at the top of the

1 page, you say that, "The emergence of broadband
2 communications as a substitute for first class mail
3 means that the Postal Service old business model can
4 no longer work," correct?

5 A Yes.

6 Q Okay, and then on page seven, line twenty-
7 two, you say, "The Postal Service can no longer rely
8 on its former business model in which growth in the
9 demand for first class mail was expected to pay the
10 bulk of the institutional costs of the Postal
11 network," correct?

12 A Yes.

13 Q When you refer to the "old business model
14 that no longer works and that can no longer be relied
15 upon," are you referring to anything that has to do
16 with a rate setting process? Are you simply talking
17 about the Postal Service's reliance on first class
18 mail to pay a certain share of institutional costs; or
19 are you criticizing the rate making process that we go
20 through here where we try to balance revenues and
21 costs in a perspective test year? Are you criticizing
22 that?

23 A No, I'm criticizing the allocation of
24 institutional costs in a way that expects that cost
25 recovery to come out of the rates for first class

1 mail.

2 Q Okay, so really, you're commenting on the
3 veracity of predictions that go into the estimates of
4 revenues and volumes in the test year. You're not
5 criticizing on the rates are set completely here. I
6 mean, you're not disputing the notion that we can have
7 a forward test year that we can estimate volumes, we
8 can estimate revenues, estimate costs, roll then
9 forward to the future. That doesn't disturb you,
10 correct?

11 A Yes, I'm not attacking the rate-making
12 process, no.

13 Q Your criticism is simply the quality of the
14 projection of the diversion of first class mail.

15 A Yes, and the ramifications of getting it
16 wrong.

17 Q Right, okay, let's look at page three. Line
18 fifteen is one of the places where you talk about,
19 "standard commercial mail will exceed first class mail
20 in volume in the test year," correct?

21 A Yes.

22 Q Okay, and then you describe this --

23 A That's figure one on page nine that presents
24 that visually.

25 Q Okay, and then page four, line five, you

1 call this a "fundamental change", and my favorite is
2 on page seven, the "tectonic" because I had to look
3 that up. You're talking about literally "the earth is
4 shaking below our feet."

5 A The earth shaking, yes -- I grew up in
6 Southern California near the San Andreas fault.

7 Q Okay, so first class diversion is equivalent
8 to the earth shaking under our feet in this
9 illustration.

10 A Yes.

11 Q So in the face of all of these, what you
12 call, "profound fundamental tectonic changes" in the
13 mail stream, do you have a view that those cannot be
14 anticipated, dealt with, addressed, in the context of
15 this rate case; that there is a -- well, I guess I can
16 withdraw this question, because you answered it. You
17 were not criticizing the rate setting process; but
18 rather the projections. So I will withdraw my
19 question. Because otherwise, I think we'll delay this
20 unnecessarily.

21 But there is one place on page five, line
22 eight, where you appear to be criticizing Witness
23 Mitchell as relying on testimony from past
24 proceedings. It's on line eight of page five. Do you
25 see that? I'm not sure you're criticizing.

1 A Right.

2 Q You say, "Mitchell and Prescott rely on
3 testimony from past proceedings." Do you see that?

4 A Yes.

5 Q And I'm trying to understand, are you saying
6 that because the earth is shaking and these profound
7 changes have occurred, that we should not look back at
8 anything we've learned in the past; we shouldn't draw
9 conclusions from the history of Postal rate making;
10 that a new day has dawned and everything has to be
11 done afresh? Are you criticizing? Is this a
12 criticism of Mitchell and Prescott?

13 A Yes.

14 Q Tell me why.

15 A Well, earlier, counsel for the Postal
16 Service was showing me Professor Spalburr's testimony
17 from 1994. Here we're talking about testimony from
18 1995.

19 What has happened in the 11 or 12 years
20 since that evidence was received by the Postal Rate
21 Commission, what has happened in particular in
22 electronic communications that changes the degree to
23 which there will be diversion of communications from
24 first class to electronic substitutes? I think there
25 are a number of significant changes.

1 Q Okay, can I say that yes, as to changes, I
2 understand. But if you base your proposals on current
3 conditions, current elasticities, current costs, and
4 you also add to that in testimony, the history of how
5 we got to where we are and what people thought along
6 the way and sent it out quite clearly, there's nothing
7 inherently wrong with that, is there?

8 A I think there is. I just don't think it's
9 very useful. I mean, it's like saying, what's going
10 to happen in the telecom industry next year?

11 Well, let's look at what happened in 1994.
12 Well, in 1994, the industry was completely different.
13 We didn't have the 1996 Telecom Act. MCI hadn't gone
14 through bankruptcy. There hadn't been the tech bubble
15 burst. The capacity of long distance fiber optic
16 networks was not a thousand-fold, compared to what it
17 is today.

18 Q Does that cause you to make a break with the
19 past and say, everything that we've developed with all
20 the economists who testified here in the past, all the
21 distinguished economists who have come forward and
22 helped the record develop and the building of Postal
23 law, as it is, decisional law, that we now put that
24 aside, because there has been a telecommunications
25 change?

1 A I'm not saying that we stop measuring
2 institutional costs or re-define how to calculate an
3 elasticity or do the tests here differently. It's not
4 that at all.

5 It's that the basic factual evidence that
6 you put into the process has so radically changed in
7 the last decade on the telecommunications' side, that
8 if you're making some comparison of what the Postal
9 Service is doing versus what the alternative is, in
10 terms of electronic communications, you can't
11 extrapolate from what that relationship looked like a
12 decade ago, because it's so different on the telecom
13 side.

14 Q Okay, let's take elasticities that you just
15 mentioned, and let me ask you about that. Let me ask
16 you this. Aside from the changes in volume of first
17 class mail and standard mail that you talk about,
18 Witness Thress and his projections, did you look at
19 Thress' elasticities for first class mail, standard
20 regular, standard ECR?

21 A Yes and no -- I looked at it. I read his
22 testimony. I saw problems in how he was approaching
23 the elasticities. I don't regard myself as a
24 econometrician. I didn't attempt to estimate the
25 elasticities myself.

1 Q Well, would you agree that on-price
2 elasticities are an important consideration in rate
3 setting?

4 A Yes, but so are cross price elasticities.

5 Q Okay, well, I'll ask you about that in a
6 second, I promise.

7 A Good.

8 Q But as to on-price elasticities, where you
9 talk about this profound change that we've discussed,
10 do you find it not useful to look at trends in changes
11 of on-price elasticities over time; that's not
12 helpful? You apparently didn't do it in this case,
13 did you?

14 A Well, it gets to the point that, as I was
15 discussing with counsel for the Postal Service, are
16 you talking about that diminishing pool of
17 inframarginal consumers of first class mail? If so,
18 then it's useful to measure what the on-price
19 elasticity of demand for first class mail is, single
20 piece, for those people.

21 If you're asking what is happening to the
22 overall demand for first class mail, relative to other
23 substitutes, the willingness to pay of that decreasing
24 set of consumers doesn't give you a very complete
25 picture of what's happening.

1 Q So you really didn't make any historical
2 observation of, let's say, first class, on-price
3 elasticity over the last decade in writing your
4 testimony?

5 A No, I didn't.

6 Q You didn't make any such observation about
7 fundamental changes in standard regular on-price
8 elasticity.

9 A No.

10 Q And same thing for standard ECR on-price
11 elasticity?

12 A NO.

13 Q So your conclusions about the fundamental
14 and tectonic changes aren't based on any review of
15 changes of on-price elasticity over time?

16 A Well, to the extent that I'm looking at what
17 Witness Thress did, I guess I would say, yes, my
18 testimony, in that respect, does take into some
19 account, changes in elasticity over time, because
20 Thress is making his estimates. He's doing it in a
21 way that takes into account things that have changed
22 in the market, relative to when the last demand
23 elasticities were estimated.

24 Q So indirectly --

25 A Indirectly, yes.

1 Q How about cross-price elasticities? Do you
2 agree that cross-price elasticities are important in
3 rate setting?

4 A I think they're extremely important, and
5 what I immediately spotted in the Thress calculations
6 as being problematic is the one year lag on broadband
7 subscriptions. It's used to --

8 Q Right; that's not my question. My question
9 first was, if you would agree that they are important;
10 not whether there were mistakes in it. I just want to
11 get through my questions.

12 A Yes.

13 Q So if we agree they're important, did you
14 look at any changes in cross price elasticity for any
15 of these products -- first class, standard ECR,
16 standard regular -- over the last decade or so?

17 A No, and I think it would be difficult to
18 have a series of cross price elasticities over time
19 for some of the relationships that we're talking
20 about. A cross price elasticity is a change in the
21 demand for "x" with respect to a change in price of
22 "y", a percentage change in each.

23 In this case, we're talking about a change
24 in the demand, a change in the quantity consumed of
25 first class mail with respect to changes in the price

1 of broadband. It's unclear to me. As I look at
2 Thress's calculations --

3 Q Let me say, I'm not talking about cross
4 elasticities with respect to competitive products; but
5 rather each other: first class versus --

6 A No, I didn't look at that.

7 Q That's what I was trying to get at.

8 A Yes.

9 Q Would you also agree that costs and relative
10 costs are important in rating setting?

11 A Yes.

12 Q Let's look at page seven, line six. You
13 have a heading there again, where you talk about the
14 profound change in the Postal mail stream since 1995.
15 You're not referring, where you're talking about the
16 mail stream, to changes in costs or relative costs,
17 correct?

18 A No, I'm not talking about costs.

19 Q For any of the products I've just discussed
20 with you -- first class, standard regular, standard
21 ECR -- have you looked at any of the changes in costs
22 or relative costs since 1995, let's say -- the last 10
23 years or so?

24 A No.

25 Q So your conclusions, obviously they couldn't

1 have been affected by it since you didn't do it.

2 So in summary, looking at your testimony,
3 let me ask you, is it fair to say that your
4 conclusions and your recommendations in your rebuttal
5 testimony are based chiefly on two factors? One is
6 the change in volume of first class and standard mail
7 that's on your page nine in that chart; and secondly,
8 what you believe to be Witness Thress' failure to
9 properly measure the electronic diversion of first
10 class mail.

11 A Yes, I think I agree with what you just
12 said.

13 Q That that's really the main thrust of your
14 testimony.

15 A Well, I also talk about efficient component
16 pricing.

17 Q Well, let's stick with the changes in
18 relative volumes. I just have one question as to how
19 we could apply this into the rate setting process.
20 Here's my question.

21 A When you say "this" what do you mean?

22 Q What I mean is the changes that have
23 occurred in volumes of first class and standard mail
24 that are in your chart on page nine, the lessons
25 learned. I want to ask you how you would apply them

1 in our Postal **Rate** context.

2 Here's my question. This is sort of a rate
3 setting hypothetical. Let's suppose you consider all
4 relevant aspects of rate setting, and you
5 preliminarily conclude that a particular product
6 should have a rate of 40 cents. There are almost no
7 numbers in this, but that's one number, **40** cents.

8 Then you look at volume proportions over
9 time, and you conclude that that particular product or
10 sub-class, let's say, used to be **45** percent of total
11 volume and now it's 40 percent of total volume. In
12 other words, the usage of that product is going down
13 historically, let's say, over the last 10 years.

14 My question is, is there a way that you
15 translate that trend into the rate setting process?
16 In other words, do you say, well, the rate was going
17 to be **40** cents, but now I'm going to adjust the rate
18 downward because the volume is going down over time?

19 A I think that if the relative volume of that
20 class of mail is declining over time, you cannot
21 expect that it will be able to contribute the same
22 amount to the recovery of institutional costs that you
23 thought it would when it was at **45** percent rather than
24 **40**. So in essence, it's relevant to being able to
25 achieve your revenue adequacy.

1 Q Does anything else come to mind? Therefore,
2 it has to do with having a good projection in the test
3 year of what the volumes are likely to be of that
4 product, correct? We all agree we need good
5 projections of costs and volumes and revenues in the
6 test year.

7 A Right.

8 Q Is there any other sense, looking backward
9 at this chart, that would cause you to change that 40
10 cents, which was your initial rate that you developed
11 after considering all the relevant factors?

12 A Well, I would want to try to find out why it
13 is that the relative shares of different classes of
14 mail have changed over time.

15 Q You wouldn't necessarily look at this and
16 say, gee, that 40 cents is obviously too high; maybe
17 based on costs, maybe based on a reasonable coverage.
18 But because the percentage of volume share has
19 decreased over time, we're going to just arbitrarily
20 decrease the 40 cents; that would not be your
21 recommendation, wouldn't it?

22 A No, that's not my recommendation. My
23 recommendation is to understand what the demand
24 factors are that may be contributing to that shift in
25 relative shares of total volume; and recognize that

1 you have a smaller base of unit sales upon which to
2 attempt to recover institutional costs for that
3 particular class of mail.

4 Q Okay, well, thank you so much, Professor
5 Sidak. I really appreciate that.

6 A Sure.

7 MR. OLSON: We're done.

8 CHAIRMAN OMAS: Mr. Todd; please introduce
9 yourself, Mr. Todd for the record.

10 MR. TODD: I'm David Todd, representing the
11 Mail Order Association of America which is, I might
12 add, the same MOAA that was, in fact, the sponsor of
13 your colleague, Mr. Spalburr's, testimony.

14 CHAIRMAN OMAS: Mr. Todd, I think your mike
15 is not on.

16 MR. TODD: Do you want me to start again?

17 CHAIRMAN OMAS: There you go, please.

18 MR. TODD: I'm David Todd, representing the
19 Mail Order Association of America, which is MOAA, one
20 of the parties sponsoring the testimony of your
21 colleague some time ago. I might add that that
22 testimony has held up remarkably well over the years,
23 which is not always true of testimony. So I
24 congratulate your association with him.

25 CROSS EXAMINATION

1 BY MR. TODD:

2 Q I just have very brief questions. First,
3 you answered some questions from Mr. McLaughlin about
4 your chart on page nine of your testimony. Your
5 testimony, as a whole, is rebutting, in part, the
6 testimony of Mr. Prescott. I assume you've read Mr.
7 Prescott's testimony. Do you recall Mr. Prescott
8 providing volumes since the creation of the standard
9 mail ECR subclass, from beginning to date?

10 A No, I don't recall.

11 Q Well, let me represent to you that, in fact,
12 on page nineteen of Mr. Prescott's testimony, which is
13 MOAA-T-1, he does present that chart showing the
14 decline in volumes for standard mail ECR from the year
15 1998 through the projections of test year 2008.

16 Let me go back. Are you aware that standard
17 mail ECR, is separately costed, the volumes are
18 measured separately, the elasticity of the sub-class
19 is measured separately, and that this Commission,
20 because of the fact that it is sub-class, must
21 establish its rate, based upon an evaluation of the
22 pricing factors of the Act, separately?

23 A Yes, I'm aware of that from having looked at
24 the testimony.

25 Q Just one question, don't you think it was

1 much more valuable, much more informative, for your
2 chart on page nine, to have presented the volumes of
3 standard mail ECR and standard mail regular
4 separately? Wouldn't that have been much more
5 informative?

6 A I don't think so. I think that the main
7 point is that you have first class mail ceasing to be
8 the largest single class of mail. First class mail
9 traditionally has been the class of mail that has made
10 the heavy contribution to recovery of institutional
11 costs.

12 So I don't see where that basic message
13 becomes any clearer, if you take the standard
14 commercial line of the chart on page nine and split it
15 into ECR and regular.

16 Q So your testimony would be that this
17 Commission ignore the different, and really quite
18 strikingly different, volume behavior of standard mail
19 ECR and standard mail regular in making its
20 recommended decision?

21 A I think it's fine for the Commission to
22 evaluate standard and regular separately for the
23 reasons you described.

24 Q You think, in fact, it's fine; or do you
25 think it's necessary?

1 A I think it's fine. I don't know if it's
2 necessary or not.

3 Q You have no opinion as to whether or not the
4 Commission is obligated to make that evaluation
5 separately.

6 A I'm not aware that it's in the statute. If
7 it's been created as a matter of administrative law
8 here at the PRC, I certainly am not aware of that,
9 because I just don't practice in front of the Postal
10 Rate Commission as a lawyer.

11 Q All right, a final question, you talk a lot
12 about electronic diversion. I take it, you have not,
13 in any way, attempted to examine the electronic
14 diversion that may be going on with respect to
15 standard mail.

16 A All sub-classes?

17 Q Standard mail ECR.

18 A I have not attempted to do any kind of
19 separate estimate, no. As I said earlier, I'm doing
20 this qualitative evaluation of what's happening.

21 Q So you haven't examined the extent to which
22 a catalog, Matt Miller's, the extent to which
23 catalogs, which traditionally have been first of all
24 mail order and then finally order -- the extent to
25 which that means of selling has shifted to, instead of

1 ordering from a catalog; ordering off the Internet,
2 off an Internet site. You haven't taken a look at
3 that. Is that correct?

4 A No, I haven't tried to measure it, no.

5 Q Have you even looked at it? I'm not asking
6 you if you measured it. Did you even consider it?

7 A Yes, I've considered it. But I haven't made
8 any attempt to quantify it.

9 Q Well, how did you consider it?

10 A Well, I thought about ECR and I thought
11 about regular; and I thought I little bit about what
12 is the effect of electronic diversion on the two
13 different sub-classes.

14 Q Did you do any examination or in any way
15 attempt to determine the extent to which the Internet
16 is now being used by traditional catalog companies,
17 for the purpose of advertising and selling their
18 products?

19 A No.

20 MR. TODD: Thank you; that's all I have, Mr.
21 Chairman.

22 CHAIRMAN OMAS: Thank you, Mr. Todd.

23 Is there anyone who wishes to cross Mr.
24 Sidak?

25 (No response.)

1 CHAIRMAN OMAS: Commissioner Goldway?

2 COMMISSIONER GOLDWAY: Thank you, Chairman.

3 I think the message, as I understand your
4 testimony, was that any business that hopes to have a
5 future needs to realistically recognize which of its
6 product lines are growing and which ones are
7 shrinking, and count on revenues from the product
8 lines that are growing, rather than the product lines
9 that are shrinking. Is that the bottom line?

10 THE WITNESS: I think that's a good summary,
11 yes.

12 COMMISSIONER GOLDWAY: So all the
13 questioning about whether you figured on this
14 particular cross elasticity or this history of
15 declining or increasing on-price elasticities doesn't
16 really relate to the bottom line, hard nosed business
17 message that I think you presented pretty clearly
18 here.

19 My concern is that the Postal Service has a
20 certain social obligation, as well as a business
21 obligation -- a business obligation to stay in
22 business and to somehow make advertising mail and
23 business-related mail efficient; but also to provide a
24 communications network, a back-up low-tech
25 communications network for all of us.

1 So what do we do about that, if the only
2 place we're going to be ultimately making revenue is
3 in advertising mail?

4 One of the questions I have for you is
5 whether, in looking at first class mail as product and
6 comparing it to the alternatives, which they've gone
7 to, we realize that people are using that because, for
8 some reason, it's more efficient or it has more
9 impact.

10 Advertising seems to have more impact, or at
11 least as much impact, in hard copy. So that's why
12 it's growing. People like that coupon in the mail.
13 They get a booklet, and it gets them to the Internet
14 to buy things. There's a reason why advertising mail
15 is growing.

16 What could first class mail do that would
17 make it something that was relevant? Maybe it would
18 not be in the largest numbers that it has; maybe it
19 would still shrink. But maybe there are areas where
20 you could rationally, as going concern, say we can
21 get revenue out of that.

22 It seems that priority mail, at least in the
23 last couple of years, is growing. We're getting some
24 additional revenue out of that.

25 I think I don't know whether you have any

1 opinions on that. But do you have any, or do you know
2 where we might look for such options?

3 **THE WITNESS:** You raise a lot of points.
4 Let me try to go through each of them.

5 I agree with you completely that the change
6 in the advertising industry is having a tremendous
7 effect on both the mail and electronic communications.
8 Yesterday, Google stock closed at a level that meant
9 the company had a capitalization of \$150 billion.
10 That has quintupled since the second quarter of 2004.
11 That is a company that earns all of its revenue from
12 advertising. It didn't exist just a short time ago, a
13 decade ago, roughly.

14 What is Google's business model, that is
15 fueled by all these advertising revenues, in part, it
16 gives away things. It gives away "search." It's
17 experimenting with giving away broadband access.

18 This fundamentally changes the way
19 traditional network industries that provide
20 communication services have to think about how they
21 will cover the common costs of the networks. Because
22 there is tremendous pressure on traditional
23 subscriber-based or usage-based revenue models for
24 supporting those industries.

25 So I don't have any easy answers for you,

1 and I'm not sure that it's even something that can be
2 adequately addressed in the context of a rate case. I
3 certainly agree with recommendations of the Postal
4 Service to shift overhead costs away from first class
5 mail to standard. I just wonder whether they go far
6 enough, in light of the changes that we're seeing and
7 the degree to which I think we will continue to see
8 consumers shifting away from first class mail.

9 You mentioned priority mail. I think
10 priority mail is a very significant example of a
11 category of mail that benefits from electronic
12 communications. Think of all of the priority mail
13 volume that is generated from eBay transactions, for
14 example. So I think it's quite possible that certain
15 categories of mail have demand that is complementary
16 to electronic communications, rather than being
17 substitutes for electronic communications. And that's
18 probably an area, I'm sure, that the Postal Service is
19 thinking about just in terms of strategic planning,
20 but that's certainly an area that requires some
21 consideration in the rate making process, too.

22 **COMMISSIONER GOLDWAY:** If we assume that
23 there will be another rate case sooner rather than
24 later, what kind of information should we be looking
25 for to make more grounded decisions on how to shift

1 institutional costs from first class to standard mail?

2 THE WITNESS: Well, first of all, and this
3 is obvious, have costing standards that attempt to
4 attribute more of the total costs of the Postal
5 Service to individual products so that the problem of
6 allocating institutional costs is not as great in the
7 future as it is in the past, but that's more easily
8 said than done.

9 I think that in terms of looking at
10 evaluating future volume of classes of mail in terms
11 of how electronic communications will affect them, it
12 would be useful to try to measure some of these cross
13 elasticities that we were discussing a moment ago.
14 I think it's very important to try to figure what is
15 the cross price relationship -- it may not even be a
16 price that you're looking at -- what is the elasticity
17 of demand for first class mail with respect to
18 different measures of broadband usage or penetration
19 or is it the price of broadband. You can specify that
20 demand relationship a lot of different ways, see
21 what's most powerful in terms of explaining the
22 migration of first class customers to electronic
23 communications.

24 The Federal Communications Commission
25 compiles a tremendous amount of data on broadband

1 markets. They put out a report every six months that
2 includes broadband subscriptions. I would really urge
3 this commission to sit down with the FCC and make sure
4 that you're getting all that information as soon as
5 it's available.

6 COMMISSIONER GOLDWAY: Thank you. That's
7 really useful. I appreciate it.

8 I have no other questions. Thanks for your
9 testimony.

10 CHAIRMAN OMAS: Thank you, Commissioner
11 Goldway.

12 Is there anyone else who wishes to cross?

13 MR. KOETTING: Mr. Chairman, I would like to
14 follow up on that a little bit.

15 FURTHER CROSS-EXAMINATION

16 BY MR. KOETTING:

17 Q Professor Sidak, your comments about the
18 various measures of Internet usage and penetration and
19 what not, you talked about looking at that in a
20 variety of ways. Are you familiar with the Joist
21 trial materials provided by Witness Thriss where he
22 lays out the different things that he explored in
23 trying to come to the best formulation he could?

24 A Well, as I said earlier, I'm not the
25 econometrician. You should certainly ask Dr. Ingraham

1 some of these questions, but I have looked at the
2 Thriss testimony and I guess I have two general
3 comments about it. Well, three. One is I'm not sure
4 why you want to lag the number of broadband
5 subscribers by a year. If you look at Figure 2 in my
6 testimony, you'll see broadband lines and broadband
7 users is growing very, very quickly and so if you're
8 lagging by a year, it seems to me that you're not
9 taking advantage of some good information that's
10 publicly available. So that's one thing.

11 The second thing, even if you take the
12 Thriss elasticity estimates with respect to first
13 class mail, if you simply apply them to the observed
14 levels of broadband users or lines that we have for
15 2005 and that we preliminarily have for 2006 and
16 certainly soon will have hard data for, I think you're
17 going to get a much larger projection of demand
18 diversion than he got simply because he was looking at
19 data that was a few years older. So that's point
20 number two.

21 Point number three is as I look at Table 16
22 in his testimony, econometric demand equation for
23 first class work shared letters, it's not immediately
24 obvious to me how he's estimating the cross price
25 elasticity here or even if it is a cross price

1 elasticity as opposed to a cross volume elasticity or
2 cross subscription elasticity and I looked at his
3 coefficients here and it's not clear to me why he's
4 setting up a dummy variable for the fourth quarter of
5 2002, for example. There are data on broadband
6 subscriptions more recent than 2002, so I don't
7 understand why you have to introduce a dummy variable
8 on top of a series of actual subscription data. So
9 that's my third point, just come up with a little more
10 straightforward way to model the cross demand effect.

11 Q Well, to deal with your third point first,
12 I take it you didn't explore any of that?

13 A It's not in my job description. I'm not the
14 econometrician.

15 Q Right. There was an opportunity to explore
16 all that with Mr. Thriss when he presented his direct
17 testimony, correct? Had it been within someone's job
18 description to do that?

19 A I think you're asking a question of
20 Mr. Baker, not me.

21 Q Well, I want to go to your first point,
22 however, where you talk about the one-year lag.
23 You're saying that you're doing qualitative work and
24 not quantitative work, but when the question is the
25 effect of the Internet, developed from the Internet,

1 on mail volume, isn't that an empirical question?
2 Whether or not the effect on mail volume shows up a
3 year later or not, isn't that an empirical question?

4 A It's an empirical question, so you're saying
5 I can't talk about it?

6 Q What I'm wondering is your status as a
7 telecommunications expert, how does that give you any
8 particular insight into how long it takes for
9 developments in the telecommunications sector, such as
10 broadband, if that's part of the telecommunications
11 sector, excuse me if it's not, to show up in mail
12 volume? I mean, isn't that what Witness Thriss is
13 empirically trying to examine? If is analysis shows
14 that it takes a year, on average, for people who
15 become broadband subscribers before it starts
16 affecting the amount of mail that they send, isn't
17 that an empirical question, rather than one that you
18 can shed a particular light on as a telecommunications
19 expert?

20 A It's an empirical question, but people ask
21 me to look at empirical data all the time and give
22 them a reaction as to whether it makes sense in the
23 real world. This fails a reality check in the sense
24 of not even mentioning, as far as I am aware, two
25 really big institutional changes: number one, the

1 deregulation of DSL by the FCC; number two, the
2 Supreme Court's decision in Brand X. The net effect
3 of those two decisions was to open up the broadband
4 market, essentially unleash much greater competition
5 particularly from DSL.

6 Before DSL was deregulated in the summer of
7 2005, the market shares nationally for broadband
8 access were roughly two-thirds cable modem, one-third
9 DSL. After the FCC removed the unbundling regulations
10 on DSL, there immediately began this convergence
11 toward 50 percent parity market shares between the two
12 residential broadband access options. So that in turn
13 implies price competition, quality competition.
14 That's all happened in less than the last 18 months
15 and that's really important.

16 Q But if it happened in the last 18 months,
17 how does Witness Thriss have quantitative data that he
18 can put into his regression analysis and draw firm
19 conclusions on the effects of that on mail volume,
20 which is ultimately what he's trying to model?

21 A Off the top of my head, I don't remember
22 when Witness Thriss' testimony was filed, so I can't
23 tell you what the most current data were that he could
24 have used at that time, but I'm just looking at the
25 sources that I cite beneath Figure 2. The Wireline

1 Competition Bureau report at the FCC called High Speed
2 Services for Internet Access, that comes out every six
3 months, so that certainly is readily available. One
4 of those other sources is something from September of
5 2005.

6 Q But, again, the mere fact that something
7 happened at the very end of the sample period he was
8 investigating makes it very difficult for him to
9 incorporate that into his regression analysis when he
10 needs to have a time series of data to draw his
11 conclusions, correct?

12 A That's a legitimate point, but it goes to
13 the question and it comes back to your point, is this
14 a qualitative or a quantitative critique. After you
15 come up with the econometric estimates that are time
16 series estimates that by definition don't enable you
17 to measure the impact of the most recent regulatory
18 developments in telecom that have an impact on
19 competition in the broadband market, how then do you
20 interpret your econometric results?

21 It seems to me you have to put an asterisk
22 by them and say does not take into account big bang
23 effect of broadband deregulation in 2005 followed by
24 intense price competition.

25 Q If one were to do that, conceivably, would

1 it just mimic a judgmental adjustment to the forecast
2 moving forward, to try to say this is the best we
3 could do with econometrics based on history as it
4 developed over the time period for which we had data,
5 but because these things happened perhaps you need to
6 make some judgmental adjustments going forward for
7 forecasting purposes? Is that the type of thing
8 you're suggesting?

9 A Yes. I mean, I think his basic story is
10 correct, he's pointing in the right direction. There
11 is a lot of substitution away from first class mail to
12 broadband-based communications services, but I think
13 it's actually considerably more powerful than what
14 he's able to capture in the time series that he's able
15 to put together. So that's my qualitative addendum to
16 what he's able to do quantitatively.

17 MR. KOETTING: Thank you, Professor.

18 Thank you, Mr. Chairman.

19 CHAIRMAN OMAS: Thank you, Mr. Koetting.

20 Is there anyone else who wishes to
21 cross-examine this witness?

22 (No response.)

23 CHAIRMAN OMAS: Mr. Baker, would you like
24 some time with your witness?

25 MR. BAKER: Sure, Mr. Chairman.

1 CHAIRMAN OMAS: About how much?

2 MR. BAKER: I don't know. Do you want to
3 take your afternoon break now? Five or ten minutes?

4 CHAIRMAN OMAS: All right. We can give the
5 witness a break.

6 Why don't we come back at about 3:30? Why
7 don't we make it 3:40?

8 (A brief recess was taken.)

9 CHAIRMAN OMAS: Mr. Baker?

10 MR. BAKER: We have no redirect,
11 Mr. Chairman.

12 CHAIRMAN OMAS: Thank you, Mr. Baker.

13 Dr. Sidak, that concludes your testimony
14 here today. We appreciate your contribution to the
15 record and your appearance here today and you are now
16 excused. Thank you very much.

17 THE WITNESS: Thank you, Mr. Chairman

18 (The witness was excused.)

19 CHAIRMAN OMAS: Mr. Todd?

20 MR. TODD: Mr. Chairman, David Todd. I
21 would like to ask Mr. Roger Prescott to come to the
22 stand.

23 Whereupon,

24 ROGER C. PRESCOTT

25 having been previously duly sworn, was

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1 recalled as a witness herein and was examined and
2 testified further as follows:

3 CHAIRMAN OMAS: Mr. Prescott, you may be
4 seated. I think you are already under oath in this
5 case.

6 THE WITNESS: Yes, sir.

7 CHAIRMAN OMAS: Thank you.

8 You may proceed, Mr. Todd.

9 DIRECT EXAMINATION

10 BY MR. TODD:

11 Q Could you give your name?

12 A My name is Roger Prescott.

13 Q And are you the Roger Prescott that
14 presented testimony in this case identified as
15 Rebuttal Testimony of Roger C. Prescott, MOAA-RT-1?

16 A Yes, I am.

17 Q You have two copies of that testimony before
18 you. Was this testimony prepared by you or under your
19 direction?

20 A Yes, it was.

21 Q And do you have any changes that you would
22 like to make in the testimony that was filed earlier?

23 A Yes, I do. I have two minor changes.

24 Q Would you please identify those?

25 A Yes. On page 16, in footnote 19, which

1 currently reads, "8.4 cents per piece for flats versus
2 8.2 cents per piece for letters," that should read,
3 "8.6 cents per piece for flats versus 8.4 cents per
4 piece for letters."

5 And then on page 21, in footnote 28, at the
6 end of that sentence, it says "Cell G241." That
7 should read, "Cell G247."

8 Q Thank you. Do either of those changes
9 affect the reasoning or conclusions that you have made
10 in your testimony?

11 A No, they do not.

12 MR. TODD: Mr. Chairman, I will present to
13 the reporter two copies of the testimony. The changes
14 that have been identified have been made in those
15 copies.

16 CHAIRMAN OMAS: Is there any objection?

17 (No response.)

18 CHAIRMAN OMAS: Hearing none, I will direct
19 counsel to provide the reporter with two copies of the
20 corrected testimony of Roger C. Prescott. That
21 testimony is received into evidence and is to be
22 transcribed into the record.

23 //

24 //

25 //

1 (The document referred to was
2 marked for identification as
3 Exhibit No. MOAA-RT-1 and was
4 received in evidence.)
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Postal Rate Commission
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**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001**

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

**REBUTTAL TESTIMONY
OF
ROGER C. PRESCOTT**

***On* Behalf Of
MAIL ORDER ASSOCIATION OF AMERICA**

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Due Date: November 20, 2006

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LIST OF WORKPAPER EXHIBITS

<u>ITEM</u> (1)	<u>TITLE</u> (2)
MOAA-LR-1	WP-STDECR-R0621 with MOAA revisions.xls

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MOAA-RT-1

1 **REBUTTAL TESTIMONY**

2 **OF**

3 **ROGER C. PRESCOTT**

4 My name is Roger C. Prescott. I am an economist and Executive Vice President of the
 5 economic consulting firm of L. E. Peabody & Associates, Inc. The firm's offices are located
 6 at 1501 Duke Street, Suite 200, Alexandria, Virginia 22314 and 5901 N. Cicero Avenue, Suite
 7 504, Chicago, Illinois 60646. I am the same Roger C. Prescott who previously submitted Direct
 8 Testimony in this proceeding on September 6, 2006 on behalf of the Mail Order Association of
 9 America ("MOAA"). My qualifications were attached as Appendix A to my Direct Testimony.

10 In this proceeding, the rates for Commercial Enhanced Carrier Route ("ECR") mail at
 11 the Basic level as proposed by the United States Postal Service ("USPS") are shown in Table
 12 1 below:

13 Table 1
 14 **USPS's Prowsed Rates For Commercial ECR Mail - Basic**

		Amount (cents)	
	<u>Item</u>		
	(1)	(2)	(3)
15			
16			
17	1. Piece Rated Mail (Per Piece)	23.3	23.3
18	2. Pound Rated Mail		
19	a. PerPiece	10.1	10.1
20	b. Per Pound	64.1	64.1

21 Source: USPS's Request in R2006-1, Attachment A, page 19.

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1 The **USPS** has proposed that piece rated Commercial ECR mail, at the Basic level, pay
2 **23.3** cents per piece while pound rated Commercial ECR mail at the Basic level, which weighs
3 more than 3.3 ounces, pays 10.1 cents per piece and 64.1 cents per pound. Under **the** USPS's
4 proposal, the ECR Basic rates for letters and flats are the same.

I. PURPOSE OF TESTIMONY

In this proceeding, Mr. Robert W. Mitchell (VP-T-1) submitted testimony on behalf of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. ("Valpak") responding to rates for Standard mail submitted by the USPS. Witness Mitchell states that his testimony attempts to: 1) demonstrate that the cost coverages for Standard Regular mail and Standard ECR mail should be modified; 2) support certain changes submitted by the USPS; and, 3) propose ~~an~~ alternative set of rates for Regular and ECR mail (Mitchell, page 3). As part of his modifications to the USPS's rate structure, **Witness** Mitchell suggests changes to the base rates and discounts for Regular and ECR mail which **are** intended to reflect the differences in the shape of the mail (i.e., letters, flats and parcels).

I have been asked by MOAA to evaluate the alternative set of rates presented by Witness Mitchell for ECR mail (item 3 above). In particular, I have been asked to evaluate the impact on rates by incorporating **the** letter/flat differential that Witness Mitchell proposes for ECR mail entered at the Basic rate level.

Witness Mitchell has recommended "that 100% of the cost difference [between letters and flats] be passed through into rates, at the Basic level, in ECR" (Mitchell, page **178**). Witness Mitchell **supports** this change to the USPS's proposal because, in part, he claims that letters and flats "are for all practical purposes separate products" (Mitchell, page **178**). Based on his calculation of the cost differences and his revised coverage ratios, Witness Mitchell recommends

the rates for Commercial ECR Basic mail shown in Table 2 below.¹ Table 2 also identifies the differences between the USPS's proposed rates and the rates proposed by Witness Mitchell.

Table 2
Witness Mitchell's Rates For Commercial ECR Mail - Basic

		Amount (cents)	
	<u>Item</u>		<u>Flats</u>
	(1)	(2)	(3)
	<u>Witness Mitchell's Rates 1/</u>		
	1. Piece Rated Mail (Per Piece)	18.5	20.8
	2. Pound Rated Mail		
	a. Per Piece	3.3	7.6
	b. Per Pound	64.1	64.1
	<u>Difference from USPS Proposed Rates 2/</u>		
	3. Piece Rated Mail (Per Piece)	-4.8	-2.5
	4. Pound Rated Mail		
	a. Per Piece	-6.8	-2.5
	b. Per Pound	0.0	0.0

1/ Mitchell (VP-T-1), page 190.

2/ Lines 1 and 2 above less the values in Table 1 above.

As shown in Table 2 above, Witness Mitchell's rate for piece rated mail equals 18.5 cents per piece for letters and 20.8 cents per piece for flats (Table 2, line 1). For pound rated mail, Witness Mitchell recommends that the per piece portion of the rates be set at 3.3 cents per piece for letters and 7.6 cents per piece for flats (Table 2, line 2a). The rate per pound suggested by

¹This summary adopts Witness Mitchell's modification of the coverage ratio for Standard Regular and ECR mail. My testimony does not critique his changes to the overall coverage ratios for the Standard mail subclasses. Witness Mitchell has also proposed rates for ECR Nonprofit mail. With the exception of the impact of his recommendation on the ECR Nonprofit pound rate, my Rebuttal Testimony does not critique his proposal for ECR Nonprofit mail.

0 1 Witness Mitchell equals 64.1 cents per pound (Table 2, line 2b), the same rate as proposed by
2 the USPS. When compared to the USPS rates, Witness Mitchell's rates for piece rated mail are
3 4.8 cents per piece less for letters and 2.5 cents per piece less for flats (Table 2, line 3). For
4 pound rated mail, Witness Mitchell recommends a decrease of 6.8 cents per piece for letters and
5 2.5 cents per piece for flats (Table 2, line 4a). For the weight portion of the rates for pound rated
6 mail, Witness Mitchell does not change the rate of 64.1 cents per pound proposed by the USPS
7 (Table 2, line 2b and line 4b).

8 The differences between the proposals of the USPS and Witness Mitchell derive from
9 Witness Mitchell's revision to the coverage ratio for ECR mail, the modification of the amount
10 of the discounts proposed by the USPS and his application of his calculated cost differences
11 between letters and flats related to mail processing and delivery costs. I have been requested by
12 MOAA to review the direct testimony, underlying workpapers and interrogatory responses of
13 Witness Mitchell to evaluate the rate differential proposed by Witness Mitchell for **letters** and
14 flats in ECR **mail**.² The results of my analyses are summarized under the following topics:

15 II. Summary and Conclusions

16 III. Historical Calculation of Basic Rates for ECR **Mail**

17 IV. ECR Basic Relationship to Regular 5-Digit Automation

18 V. Flaws in Witness Mitchell's Proposal

²Witness Mitchell also proposes a revised rate differential for ECR automation letters and parcels. While much of my critique of **his** rate differentials for letters and **flats** is, in general, **equally** applicable to his calculations for automation letters and parcels, this Rebuttal Testimony addresses **the** proposed letter/flat changes.

II. SUMMARY AND CONCLUSIONS

Based on my review and analysis of Witness Mitchell's proposed rates for Commercial ECR mail at the Basic level, my summary and conclusions include:

1. The adoption of Witness Mitchell's proposed letter/flat rate differential would disrupt the relationship between the Commercial ECR Basic **letter** rate and the letter rates in the Standard Regular subclass for 5-digit automation mail. The application of Witness Mitchell's proposed letter flat differential to **the** rates shown in **USPS's** Witness Keifer's workpapers would result in a rate for ECR Basic letters that is 0.4 cents per piece lower than the rate for Standard Regular 5-digit automation mail. This would prevent the migration of much, or all, of the mail expected to shift from ECR Basic to Standard Regular and would thwart the USPS's goal of increasing the amount of automation mail.
2. The cost difference between **letters** and flats calculated by Witness Mitchell considers only the differences in mail processing and delivery costs. If the Basic rates for letters and flats are to be separated based on costs, then a thorough cost analysis, considering the impact of weight difference between letters and flats on the average costs, needs to be presented. One study relied upon by Witness Mitchell, which does not consider these weight differences, suggests that the total cost difference between ECR letters and ECR flats shows only a small differential in average costs of 0.2 cents per piece.
3. Witness Mitchell's claim that flats show no contribution to institutional costs is misleading because his claim is based on a study of mail for one specific mailer that reflects only 0.4 percent of the total volume and combines ECR mail with Standard Regular mail. In fact, the study referenced by Witness Mitchell shows that ECR flats and ECR letters both make substantial and nearly equal contributions on a per piece basis to institutional costs.
4. Witness Mitchell's proposed **rate** design is flawed because he fails to **recognize** that part of the cost difference is due to the variation in **the** average weight between letters and flats. Therefore, any differential between letters and flats must be accompanied by changes in the pound rate.
5. Witness Mitchell's proposal would create a rate structure for ECR Nonprofit mail that results in a negative per piece rate for high density and saturation mail which weighs more than 3.3 ounces, an obviously unacceptable rate design.

III. HISTORICAL CALCULATION OF BASIC RATES FOR ECR MAIL

The Standard class for mail, with the Standard Regular and ECR subclasses, was established in the MC95-1³ proceeding. In that proceeding, the rates at **the** ECR Basic level included a differential between letters and flats of 0.5 cents per **piece**.⁴ Beginning with the R97-1 proceeding,⁵ and in all of the subsequent proceedings, the PRC has accepted a rate structure where letters and flats at the ECR Basic level paid the same rates.⁶ In other words, the rate structure has looked like the format shown in Table 1 above.

Since MC95-1, Valpak, through the testimony of Witness Haldi or Witness Mitchell, has advocated for a rate differential or separate rates for ECR letters and flats. For example, in MC95-1, Valpak's Witness Haldi asserted that the "cost differences between carrier route letters and flats warrants separate rate treatment."⁷ While the PRC did adopt different rate categories for letters and flats within the ECR subclass, the PRC also noted that "special consideration has been given to the Postal Service's concern that lower rates for carrier route letter mail will be counterproductive to the Service's letter mail automation program."⁸

³PRC Docket No. MC95-1, Mail Classification Schedule, 1995, Classification Reform I, Opinion and Recommended Decision dated **January** 26, 1996 ("MC95-1").

⁴MC95-1 Decision, Appendix One, Rate Schedule 321.3.

⁵PRC Docket No. R97-1, Postal Rate and Fee Changes, 1997, Opinion and Recommended Decision dated May 11, 1998 ("R97-1").

⁶I recognize that, beginning with the MC95-1 decision and **all** subsequent decisions, letters and flats have paid different rates for mail at **the** high density and saturation level.

⁷MC95-1 Decision, page V-230.

⁸MC95-1 Decision, page V-238.

0 1 **As** recognized in the PRC's decision in R97-1, the USPS's objective in eliminating the rate
2 differential between ECR Basic **letters** and Basic flats was to provide incentive for mailers to enter
3 the letter mail as Basic automation in ECR or 5-digit automation in the Standard Regular subclass
4 (R97-1 Decision, pages 448-449). No additional rationale exists today from what existed at the
5 time of **the** MC95-1 proceeding which supports a revision **to** the historically-accepted rate
6 structure where ECR Basic rates are the same for letters and flats.

7 In this current proceeding, Witness Mitchell relies on the PRC's response to his testimony
8 in R2005-1 as support for changing the rate structure (Mitchell, pages 118-119). While I agree
9 that the PRC's decision in R2005-1 did acknowledge Valpak's "thoughtful discussion of why
10 the letter/flat differential should be recognized in Basic ECR rates" (R2005-1 Decision, page
11 137), the PRC's R2005-1 Decision did not accept Valpak's arguments and was concerned that
12 the rate structure proposed by Witness Mitchell failed to recognize that costs are affected by
13 weight as well as shape.'

14 Additionally, Witness Mitchell entirely ignores **the** fact that the rate structure of Standard
15 Mail, in which some pieces pay a uniform piece rate, and other pieces pay both a piece and pound
16 rate, complicates the transition from per piece-rated mail to piece plus pound-rated mail. Heavy
17 minimum-per-piece rated mail entered at the maximum weight allowed for the flat rate (**3.3** ounces),
18 such as the mail of Valpak, pays the **same** rate as a mail piece of less than one ounce, i.e., the costs
19 of added weight **are** not reflected in the rates.

⁹In Section V below, I discuss in detail how Witness Mitchell's proposal is flawed because, in addition to other problems, he accepted the weight component of the rates as proposed **by** the **USPS**.

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1 I recognize that the rate structure of Standard Mail has long been in place and it is not my
2 purpose here to suggest that it should be reexamined. Nevertheless, it is pertinent to an evaluation
3 of the Direct Testimony of Witness Mitchell, which addresses only a single element of the Standard
4 Mail rate design with no consideration of the extent to which the issue addressed by him, is intrinsic
5 to the overall rate structure of Standard Mail.

IV. ECR BASIC RELATIONSHIP TO REGULAR 5-DIGIT AUTOMATION

In his Direct Testimony, Witness Mitchell believes that a rate difference for letters and flats of 2.3 cents per piece should be implemented for ECR Basic rates.” Witness Mitchell’s proposed rates, based on the Test Year Before Rates billing determinants and his revised coverage ratios, masks much of the impact of his letter/flat adjustment.

At page 42 of his Direct Testimony, Witness Mitchell asserts that ECR Basic rates for letters are **kept** high in order to maintain the current relationship between ECR Basic rates and the 5-digit automation rates in the Standard Regular subclass. Witness Mitchell rejects this relationship **as** a valid concern. While my testimony here does not attempt to critique what the relationship between ECR Basic rates and Standard Regular 5-digit automation rates should be, the impact of Witness Mitchell’s proposed rate structures should be considered and evaluated before his rates are accepted.

In the past, the PRC has followed a process of oversight regarding the rate relationships between **the** Standard **Regular** and ECR subclasses. For example, in R2000-1, the PRC stated:

“Additional objectives include creating (or maintaining) appropriate rate relationships, such as ensuring that the 5-digit automation letter rate is lower than the basic ECR letter rate, but higher than **the** basic ECR automation letter rate; avoiding rate anomalies; providing for more cost-based rates; and achieving results that **are** reasonable, in terms of an overall perspective” (R2000-1 Decision, pages 338-339).

¹⁰ Witness Mitchell calculates the mail processing and delivery costs for Basic letters at 9.317 cents per piece while his calculation of the cost for Basic flats equals 11.636 cents per piece (Mitchell, pages 178-179). **The** cost difference claimed by Witness Mitchell equals 2.3 19 cents per piece or **2.3** cents per piece rounded. **As** noted at page 180 of his Direct Testimony, Witness Mitchell’s costs are based on utilizing the “PRC Method” for costing. If the **USPS’s** costs **are utilized**, as developed by the **USPS’s** Witness Kiefer, the costs equal 9.51 cents per piece for letters and 11.09 cents per piece for flats, a difference **of** 1.6 cents per piece.

1 The letter/flat differential proposed by Witness Mitchell in this proceeding would defeat
2 some of the PRC's objectives." In the current proceeding, the USPS has stated that setting Basic
3 letter/flat rates at the same level "would best support the Postal Service's goal of promoting
4 automation and sequencing of letters at plants to the extent possible."¹² Witness Mitchell no longer
5 sees any need to maintain this relationship.

6 In order to test the impact of Witness Mitchell's letter/flat differential on Test Year After
7 Rates, I have modified the ECR rate and revenue worksheet submitted by USPS's Witness Kiefer
8 (USPS-T-36) in this proceeding." For my analysis, I have accepted the ECR discounts for density
9 and dropshipping as proposed by Witness Kiefer as well as his overall revenue requirement for the
10 ECR revenue subclass. My analysis is included with my workpapers as MOAA-LR-I, in a
11 spreadsheet titled "WP-STDECR-R0621 with MOAA revisions.xls." In the spreadsheet, I made
12 several changes to the level titled "Proposed Rates."¹⁴ The Basic rate for letters (cell H25) was
13 adjusted to equal 2.3 cents less than the Basic rate for flats (cell H30). The piece rate for mail
14 weighing greater than 3.3 ounces were all set to equal the rate for origin entered mail (cells M25,
15 N25, M30, N30 and O30). The Basic rates per piece (cells D7 and E7) were adjusted until the
16 required revenues shown by Witness Kiefer (\$5.956 billion) were reached, assuming a 2.3 cent per
17 piece differential were in place. The results of my analysis are summarized in Table 3 below:

"Following Witness Mitchell's "presort tree", the 2.3 cents per piece differential is incorporated into all rate categories for ECR mail.

¹²See response of Witness Kiefer to NAA/USPS-T36-1

¹³See USPS Library Reference-L-36, spreadsheet WP-STDECR-R0621.xls.

¹⁴For purposes of this analysis, I have accepted the coverage ratio and revenue requirement for ECR mail that Witness Kiefer utilized. My Direct Testimony in this proceeding on behalf of MOAA advocates a reduction in the coverage ratio for ECR mail.

Table 3
Rates for Commercial ECR Mail - Basic
 (TYAR Rates With Letter/Flat Differential)

		Amount (cents)	
	<u>Item</u>	<u>Letters</u>	<u>Flats</u>
	(1)	(2)	(3)
	<u>Revised TYAR Rates 1/</u>		
	1. Piece Rated Mail (Per Piece)	21.5	23.8
	2. Pound Rated Mail		
	a. Per Piece	8.3	10.6
	b. Per Pound	64.1	64.1
	<u>Difference from USPS Proposed Rates 2/</u>		
	3. Piece Rated Mail (Per Piece)	-1.8	0.5
	4. Pound Rated Mail		
	a. Per Piece	-1.8	0.5
	b. Per Pound	0.0	0.0

1/ MOAA-LR-1, WP-STDECR-R0621 with MOAA revisions.xls, level "Proposed Rates".

2/ Lines 1 and 2 above less the values in Table 1 above

Based on my analysis, the Basic rate for flats would be increased from 23.3 cents per piece to 23.8 cents per piece (Table 3, line 1 above) and the per piece portion of the pound rate would increase from 10.1 cents per piece to 10.6 cents per piece (Table 3, line 2a above). This reflects an increase of 0.5 cents per piece. For Basic letters, the revised rate equals 21.5 cents per piece and the piece portion of the pound rate equals 8.3 cents per piece (Table 3, column (2), lines 1 and 2a). These rates are 1.8 cents per piece less than the rates proposed by the USPS (Table 3, column (2), line 3 and 4a). Rates set at this level would produce ECR revenues of \$5.974 billion, 0.3 percent higher than the revenues calculated by Witness Kiefer.

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MOAA-RT-1

1 The current rate for ECR flats entered at **the** Basic level equals 20.4 cents per piece. The
2 USPS's proposed rate in Table 1 above equals **23.3** cents per piece, an increase of **14** percent.
3 Based on Witness Mitchell's letter/flat rate differential, **the** ECR flat rate would increase to **23.8**
4 cents per piece, an increase of 17 percent. Witness Mitchell's proposal, therefore, would have a
5 substantial impact on the rates paid by ECR flats.

6 The problem with the rates created by utilizing Witness Mitchell's letter/flat differential is
7 the resulting relationship between the ECR Basic letter rate and 5-digit automation rate for Standard
8 Regular letters, i.e., **the** problem addressed in **the** PRC's R97-1 and R2000-1 decisions. Witness
9 Kiefer has proposed a 5-digit automation rate for Standard Regular ~~mail~~ of 21.9 cents per piece.
10 Under Witness **Kiefer's** proposed rates, the difference between **the** ECR Basic **letters** and Standard
11 Regular 5-digit automation rates equaled 1.4 cents per piece (**23.3** cents per piece less 21.9 cents
12 per piece).¹⁵ If Witness Mitchell's proposed letter/flat **rate** differential is incorporated into Witness
13 **Kiefer's** proposed rate structure, ECR Basic letters will pay **21.5** cents per piece, which is 0.4 cents
14 per piece less than the 5-digit automation rate.

15 In my opinion, because of **the** lower ECR Basic rate, the **letter** shaped mail paying the 5-digit
16 automation rate in Regular will migrate to ECR or, alternatively, the automation mail that the **USPS**
17 has assumed will migrate to Standard Regular will not migrate at all. This potential problem **was**
18 addressed by the USPS when it stated that **the** "reduction or reversal of **the** rate differential [between
19 Basic ECR and Standard Regular 5-digit automation letters] would diminish **the** incentive **for**
20 mailers to prepare larger trays of 5-digit presorted automation compatible letters that can be directly

¹⁵The rate differential for **letters** entered at the DBMC and **DSCF** also equaled **1.4** cents per piece.

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MOAA-RT-1

1 delivery point sequenced at plants...[which is] **less** supportive of **the** Postal Service's letter
2 automation goal..."¹⁶

3 I would note that Witness Mitchell's proposal essentially penalizes flats for a rate problem
4 related to letters. There is no basis to assume that ECR Basic flats do not provide substantial
5 contribution to institutional costs and, in fact, as shown below, evidence exists to show that ECR
6 flats and letters provide for approximately the **same** level of contribution. Therefore, the rates for
7 ECR flats should not be increased above a level proposed by the USPS in this proceeding.

8 Witness Mitchell also argues that ECR flats and **letters** are essentially different products
9 (Mitchell, page 178).¹⁷ Under this theory, Witness Mitchell would advocate for a separate mark-up
10 or coverage ratio for ECR letters and flats. Since the establishment of the ECR subclass, the PRC
11 has always combined **the** letter and flat products in ECR before applying the coverage ratios. In
12 other words, the PRC develops coverage ratios for each subclass, not each rate category. In MC95-
13 1, the PRC rejected the proposition that subclass treatment, and separate markups, can be premised
14 solely on the basis of the cost differences of a particular type of mail.¹⁸ Witness Mitchell has given
15 no reason for the PRC to alter that conclusion.

¹⁶See Witness Kiefer's response to NAA/USPS-T36-13.

¹⁷See also, e.g., Tr. 25/8950.

¹⁸MC95-1 Decision, pages I-2 to I-3 and V-160.

V. FLAWS IN WITNESS MITCHELL'S PROPOSAL

Witness Mitchell has several flaws in his approach to adjusting the ECR rates to reflect the cost differences between letters and flats. Because of these flaws, the PRC should not adopt his proposal for a letter/flat rate differential. My discussion of the flaws in Witness Mitchell's proposal *are* addressed under the following topics:

- A. Proper Use of the USPS's Costs
- B. Contribution for ECR Letters and Flats
- C. Improper Rate Differential for Pound Rate Mail
- D. Impact of Weight on Cost Differences
- E. Anomalies in Witness Mitchell's Nonprofit Pound Rate
- F. Summary

Each issue is discussed below.

A. PROPER USE OF THE USPS'S COSTS

The analysis of mail processing and delivery costs developed by the USPS is designed to calculate the cost differences and discounts related to density. The density discounts are calculated separately for letters and flats, without the consideration of the difference between letters and flats at any particular density level. In other words, the cost analysis for letters is the basis for setting the discounts for high density letter mail and saturation **letter** mail while the cost analysis for flats is **the** basis for the discounts for high density flat mail and saturation flat mail. Following the USPS's rate structure, the discount per piece is the same for piece-rated and pound-rated mail. Neither cost analysis addresses the totality of the cost difference between letter and flat shaped mail.

Witness Mitchell asserts that if the other costs in addition to mail processing and delivery costs are considered, the average costs for Basic level mail equal 9.583 cents per piece for letters and 12.518 cents per piece for flats (Mitchell, page 181). This calculation implies an even greater cost differential between **letters** and flats (2.9 cents **per** piece) than the cost differential relied upon by Witness Mitchell to calculate his letter/flat rate difference (2.3 cents per piece). Witness Mitchell's analysis is misleading. The library reference relied upon by Witness Mitchell (USPS-LR-L-135), shows only a small differential in average costs of 0.2 cents per piece between letters and flats when all costs are considered." Even this calculation of the letter/flat cost differential is not appropriate for the use that Witness Mitchell intends for two reasons. First, the average costs reflect the average weight for letter and flat mail, i.e., the costs have not been adjusted to reflect that **the** average flat weighs more than the average letter. Second, the average costs are **not** solely related to mail entered at the Basic level.

In order to develop a rate difference at the ECR Basic **level**, all of the cost differences between **letters** and flats must be analyzed. Stated differently, before a separation of the Basic rates can be made, all cost components must be analyzed, **not** the limited components related to mail processing and delivery costs. Without such **an** analysis, **the PRC** has no basis to make a determination of the cost differences related solely to the shape of the mail.

B. CONTRIBUTION FOR ECR LETTERS AND FLATS

Included in the general observations regarding the letter-flat rate differential in his Direct Testimony, Witness Mitchell refers to testimony in **MC2005-3**²⁰ sponsored by USPS Witness

¹⁹8.6 cents per piece for flats versus **8.4** cents per piece for **letters** as shown in USPS-LR-L-135, level "unit costs", cells M24 and M25.

²⁰PRC Docket **No.** MC2005-3, Rates and Service Changes to Implement Baseline Negotiated Service Agreement with Booksoan, ("MC2005-3").

1 Michelle K. Yorgey. Witness Mitchell states that the USPS testimony “shows no contribution from
2 flats, and considerable financial gain from flats converting to **letters**” (Mitchell, page 117). Witness
3 Mitchell has ignored the underlying data from the study put **forth** by Witness Yorgey and ignores
4 Valpak’s critique of the USPS’s testimony. Witness Mitchell’s incorrect conclusions regarding
5 MC2005-3 should have no bearing on the determination of the rate levels for ECR mail as it relates
6 to this current proceeding (R2006-1).

7 Witness Mitchell is correct to state that page 9 of Appendix A in Witness Yorgey testimony
8 shows financial gain to USPS from converting flats into letters. The details supporting this
9 conclusion **are** shown in the earlier pages **of** that Appendix A. However, Witness Mitchell fails to
10 acknowledge that the revenue and cost study addressed in MC2005-3 is specific to the mail of **the**
11 company addressed in that proceeding, Bookspan. Specifically, the study only calculates the impact
12 of the shift from flat shaped mail to letter shaped mail for Bookspan’s fiscal year 2004 volumes and
13 revenues. The Bookspan volume for the year analyzed (**258** million pieces) equals only **0.4** percent
14 of **the** total USPS volume for **the** Standard class of mail (66,169 million pieces).” **The** results of
15 an analysis of such a small percentage of the total volume should not be the basis **for** reaching any
16 conclusions regarding the contribution of flat mail in this current proceeding.

17 Witness Mitchell’s contention that USPS receives “no contribution from flats” (Mitchell,
18 page 117) is incorrect because he ignores the fact that the Bookspan study combined mail shipped
19 Standard Regular with mail shipped in ECR. Witness Mitchell ignores the contribution that ECR
20 **flats** make to the USPS. In the USPS’s study of Bookspan’s mail, the contribution per piece from

²¹MC2005-3, Witness Yorgey, Appendix A, page 5.

1 ECR flats is 7.1 cents per piece while the contribution per piece from ECR letters is 8.2 cents per
2 piece.²² Both shapes of mail make significant contributions to USPS's institutional costs.

3 Also, in **the** MC2005-3 proceeding, Valpak questioned the validity of Witness Yorgey's
4 study. Valpak argued that the national average costs used by the USPS were incorrect. For
5 example, Valpak's interrogatories to USPS Witness Yorgey filed on September 7, 2005 questioned
6 the development of the costs. The PRC noted Valpak's challenges to the costs used in the USPS
7 study. The PRC also noted in its decision in MC2005-3 that "Valpak argues that looking at
8 disaggregated data in this manner is appropriate because there are variations in **unit** contributions
9 between flats prepared **differently**."²³

10 In summary, the study relied upon by Witness Mitchell to **support** his claim that flats **make**
11 no contribution to institutional costs actually supports the opposite conclusion. According to the
12 MC2005-3 study, ECR letters and flats both **make** a substantial contribution to institutional costs
13 and the difference in contribution between ECR **flats** and letters is only 1.1 cents **per** piece. Witness
14 Mitchell's reliance on the MC2005-3 cost study also contradicts Valpak's position **in** that
15 proceeding where Valpak asserted that the cost study was flawed and **inappropriate** for calculating
16 the cost difference between **letters** and flats.

17 **C. IMPROPER RATE DIFFERENTIAL FOR POUND RATED MAIL**

18 Witness Mitchell claims that the rate differences between letter and flat shaped mail
19 should reflect the 2.3 cents per piece cost difference that he has calculated. Following his
20 methodology (including **his** revised coverage ratio and discounts), Witness Mitchell calculated

²²See Witness Yorgey, Appendix A, pages 5 and 6. For ECR letters, the average revenue equals 16.6 cents per piece and an average cost of 8.4 cents per piece. For ECR flats, the average revenue equals 16.9 cents per piece and an average cost of 9.8 cents per piece.

²³See PRC decision in MC2005-3 dated May **10, 2006**, page **77**.

1 a rate for ECR Basic flats of 20.8 cents per piece. Based on **the** rate differential of 2.3 cents per
2 piece, he then **set** the ECR Basic letter rate at 18.5cents per piece (20.8 cents per piece less 2.3
3 cents per **piece**).²⁴ Because Witness Mitchell does not adjust the per poundrate for pound-rated
4 mail, Witness Mitchell calculates a per piece rate for flat shaped pound-rated mail of 7.6 cents
5 which reflects the rate designed to make the pound-rated and piece-rated flat rate equal at the
6 breakpoint of 3.3 ounces.²⁵

7 As summarized in Line 2a of Table 2 above, Witness Mitchell proposes a rate **of** 3.3 cents
8 perpiece for ECR Basic pound-rated **letter** mail. This reflects a rate differential of 4.3 cents **per**
9 piece (7.6 cents per piece minus **3.3** cents per piece). Witness Mitchell's calculation is in error.
10 In developing his ECR Basic rates, Witness Mitchell included rates for automation letters which
11 reflected a discount of 2.0 cents per piece. Following his methodology, **the** automation letter rate
12 equaled 16.5centsperpiece (18.5 cents per piece from Table 2, line 1 above **less** the proposed
13 discount of 2.0 cents per piece). In order to develop his piece rate for per pound rated ECR
14 Basic letters, Witness Mitchell subtracts his difference of 4.3 cents (Basic flat rate of 20.8 cents
15 per piece less the automation letter rate **of** 16.5 cents per piece) from his pound rate of 7.6 cents
16 per **piece**.²⁶ The proper calculation, following Witness Mitchell's methodology would be to
17 subtract the cost difference of 2.3 cents per piece from **the** per piece rate for flats of 7.6 centsper
18 piece, resulting in a rate of 5.3 cents per piece for ECR Basic pound-rated letter mail. This error

²⁴See Witness Mitchell's spreadsheet titled **VP-RWM-Workpaper-8.xls**, level "inputs", cells V57 and AA52.

²⁵(64.1 cents per pound / 16 ounces x 3.3 ounces + 7.6 cents per piece) = **20.8** cents per piece.

²⁶See Witness Mitchell's spreadsheet titled **VP-RWM-Workpaper-8.xls**, level "Comm", cells G50, **G54** and K41.

1 in the per piece rate also flows through to Witness Mitchell's calculation of the per piece portion
2 of the letter rates for pound rated mail at the High Density and Saturation levels.

3 **D. IMPACT OF WEIGHT ON COST DIFFERENCES**

4 Witness Mitchell is of the opinion "that the studies done to date to estimate the effects
5 of weight on the costs of Standard Mail are indicative but not terribly reliable, then no real basis
6 exists for evaluating the pound charges" (Mitchell, page 182). He also concludes that
7 "[a]djustments in the pound rates should not affect letters" (Mitchell, page 183). Based on these
8 opinions, Witness Mitchell's proposed rate structure does not adjust the ECR rate per pound
9 proposed by the **USPS** in this proceeding.

10 While I agree that no study has been presented on the effects of weight on mail, this is
11 another reason why Witness Mitchell's separation of the Basic rates for letters and flats must be
12 ignored. Contrary to Witness Mitchell's claim, his failure to make any adjustment to the pound
13 rate does impact the rates for letters.

14 The PRC, in the R2005-1 Decision, recognized that the pound rate included the cost
15 differential between letters and flats was "likely true to some extent" (R2005-1 Decision, page
16 137). Even Valpak, which was advocating a letter/flat differential in R2005-1 as well as in this
17 proceeding, recognized that the pound rate contained some portion **of** the letter/flat cost
18 differential, although Valpak asserted "the differential might be quite small" (R2005-1 Decision,
19 page 136). The pertinent point for this proceeding is not the magnitude of the cost differential,
20 but simply the fact that Witness Mitchell has ignored this difference in calculating **his** proposed
21 rates.

22 In R97-1, the same Dr. Haldi that appears on behalf of Valpak in this proceeding was
23 critical **of** the **USPS's** failure to consider the impact of weight when determining the cost

1 differences between flats and parcels.²⁷ The same logic applies to this proceeding where the
2 impact of weight must be considered in determining the cost differential between letters and
3 flats.

4 Witness Mitchell acknowledges that the costs that he has utilized for flats in his analysis
5 (1.636 cents per piece) reflects “flats from 0 to 16 ounces, not just for flats paying the minimum
6 -per-piece rate” (Mitchell?page 179). However, only 56.9 percent of the flat mail pays the
7 minimum per piece rate.²⁸ For letter shaped mail, the percentage of mail paying the minimum
8 per piece equals 98.4 percent.²⁹

9 The average weight of **ECR** letter mail equals **0.76** ounces while the average weight for
10 **ECR** flat mail equals 3.28 ounces. **ECR** flat mail weighs 332 percent more than **ECR** letter mail.
11 More importantly, for the 43.1 percent of the **ECR** flat mail that pays based on the pound rates,
12 the average weight is **5.11** ounces, **572** percent greater than the average weight of **ECR** letter
13 mail.” According to Witness Mitchell the underlying weight characteristics of **ECR** letter and
14 flat mail does not support recognition of the impact of weight on costs. I disagree. Before any
15 separation of the **ECR** rates to recognize the cost differences between letters and flats are
16 established, the full impact of weight on costs must be understood and recognized

²⁷R97-1 Decision, page 406.

²⁸See Witness Mitchell’s Direct Testimony at page 182 and spreadsheet titled VP-RWM-Workpaper-8.xls, level “TYBR”, cell G247.

²⁹See Witness Mitchell’s spreadsheet titled VP-RWM-Workpaper-8.xls, level “TYBR”, cell D241.

³⁰The average weight figures I have utilized here are the TYBR values relied upon by Witness Mitchell. See Witness Mitchell’s spreadsheet titled VP-RWM-Workpaper-8.xls, level “TYBR”, cells D244 through D248.

1 **E. ANOMALIES IN WITNESS MITCHELL'S NONPROFIT POUND RATE**

2 The rates proposed by Witness Mitchell create an anomaly for ECR Nonprofit mail. Based
3 on Witness Mitchell's proposed rate structure, he recommends that **the** per piece portion of the
4 pound rate should be set at a negative value. For example, Witness Mitchell proposes that the per
5 piece rate for ECR Nonprofit mail **equals** (-)0.3 cents per piece for High Density mail and (-)1.2
6 cents per piece for Saturation mail (Mitchell, page 191, under "Origin Auto"). While
7 mathematically **the** per piece portion of the pound rate can be solved knowing the rate for mail
8 weighing less than 3.3 ounces and a given pound rate, the logic of a negative rate should be
9 questioned. The ECR rate schedule has never had a negative rate. Essentially, Witness Mitchell's
10 approach says that for ECR Nonprofit mail weighing more than 3.3 ounces, you determine the rate
11 by taking the pound rate divided by 16 ounces, multiply that result by the weight of **the** piece and
12 then subtract an amount from that result. This creates a contradiction with the current procedures
13 and the procedures proposed by the USPS.

14 **F. SUMMARY**

15 The structure of the rates proposed by the USPS in this proceeding, as shown in Table
16 1 above, reflects that letter and flat mail at the Basic level pay **the** same rate. No reason exists
17 to change the rate structure for mail at **the** Basic level to reflect the impact of shape as proposed
18 by Witness Mitchell. In addition, no testimony has been presented in this proceeding to properly
19 modify the pound rate if such a letter/flat rate differential were adopted by the PRC. The
20 problems in Witness Mitchell's analysis related to the letter/flat differential cannot be ignored.
21 Letters and flats at the ECR Basic level should pay the same rate.

1 CHAIRMAN OMAS: This now brings us to oral
2 cross-examination. Two parties have requested oral
3 cross.

4 Ms. McKenzie, would you introduce yourself?
5 You may proceed.

6 MS. MCKENZIE: Nan McKenzie for the Postal
7 Service.

8 Mr. Chairman, we have no questions at this
9 time.

10 CHAIRMAN OMAS: Thank you, Ms. McKenzie.

11 Mr. Olson, Valpak Direct Marketing Systems,
12 and Valpak Dealers Association.

13 MR. OLSON: Thank you, Mr. Chairman.

14 CROSS-EXAMINATION

15 BY MR. OLSON:

16 Q Mr. Prescott, Bill Olson for Valpak. I want
17 to ask you to begin with looking at page 15 of your
18 testimony. Line 14 contains the following statement,
19 "The analysis of mail processing and delivery costs
20 developed by the USPS is designed to calculate the
21 cost differences and discounts related to density."
22 Correct?

23 A Yes.

24 Q Just to clarify what you mean, when you
25 refer to density, are you speaking of what people call

1 density tiers like basic and high density and
2 saturation or something else?

3 A Basic high density and saturation.

4 Q So you're talking about density tiers, in
5 that sense?

6 A Yes.

7 Q You make the statement that the costs are
8 designed to calculate cost differences related to
9 density and I don't know what you have in mind there.
10 Are you saying that they're not developed for any
11 other purpose, that there are different types of costs
12 in the record, some developed for density, some not?
13 What does it mean when a cost is designed for
14 estimating density?

15 A Well, there certainly are all kinds of
16 different costs that are in the record. What I mean
17 by this sentence, and this is just the introduction to
18 the paragraph, is when the Postal Service developed
19 their discounts for density they did a cost for
20 letters at basic high density and saturation and a
21 cost for flats at basic high density and saturation.

22 Q But they use those costs for all purposes,
23 do they not, not just determining density, cost by
24 density?

25 A Well, the costs are used for other purposes,

1 yes, in addition.

2 Q It sounded pejorative to say they were
3 designed for a particular purpose as opposed to trying
4 to get accurate costs. That's not what you mean,
5 then?

6 A No, in this instance, designed is a synonym
7 for utilized.

8 Q Okay. Okay. Let me ask you to look at page
9 16 of your testimony, line 14. You state it
10 differently, "Before a separation of the basic rates
11 can be made, all cost components must be analyzed, not
12 the limited components related to mail processing and
13 delivery costs." Correct?

14 A Yes.

15 Q And on that same page, both in footnote 19
16 and up on line 7, you reference **USPS** Library Reference
17 L135, which is entitled "Standard Mail Unit Costs by
18 Shape." Correct?

19 A Yes.

20 Q Okay. Now, are you saying that there is a
21 serious problem here, that not all cost components
22 have been analyzed, that the only ones that have been
23 looked at are those having to do with mail processing
24 and delivery and that's a weakness in the analysis?

25 A Yes, it is a weakness in the analysis. If I

1 were looking to determine the cost differentia
2 between basic letters and basic flats in standard ECR
3 mail, I would look at all costs and not just the costs
4 of mail processing and delivery.

5 Q And you view that as a big problem, a
6 serious problem?

7 A Well, it's a problem, how big a degree you
8 want to give it. I think it's a big enough problem to
9 reject the proposal put forth by Mr. Mitchell.

10 Q So it's that significant?

11 A Yes.

12 Q Do you know offhand what percentage of the
13 costs of ECR letters do not fall in the category of
14 mail processing and delivery costs?

15 A Off the top of my head, no I do not.

16 Q If I were to suggest that the last page of
17 Library Reference USPS L135 sets out for standard ECR
18 mail the letter costs for mail processing and for
19 total -- I'm sorry. Let me just go back to what you
20 said. Mail processing and delivery and I'm going to
21 ask you to accept subject to check that those two
22 categories account for 96.8 percent of all letter
23 costs. Would you accept that subject to check or if
24 you have the Library Reference you could check it, but
25 for purposes of the question, I could just ask you to

1 accept it.

2 A I'll accept it.

3 Q Okay. Let's assume that's the case. If the
4 studies don't address the totality of the cost
5 difference between letters and flats, your concern
6 would be on the 3.2 percent that are other than mail
7 processing and delivery, whatever the number is?

8 A That's not exactly comparable. You're
9 comparing an analysis that wasn't utilized for the
10 density tier discounts and trying to extrapolate
11 something that I don't think you can do. The letter
12 cost that's in Library Reference 135 is all density
13 tiers and all weight groups, so it's not a
14 head-to-head comparison.

15 Q Do you have a better estimate of what you
16 think the proper number is?

17 A I have not calculated that.

18 Q Are you saying that there are cost
19 differences between letters and flats that are not
20 reflected in the Postal Service cost studies? Is that
21 part of what you're saying at all?

22 A The term cost studies there is very vague.
23 There's a number of cost studies on the record in this
24 proceeding, so I'm not sure what you mean.

25 Q That are simply not recognized anywhere in

1 Postal Service cost studies?

2 A I don't think so. I think the IOCS picks up
3 all the costs.

4 Q Okay. Let's take a look at your testimony
5 at page 16, where you reference Bookspan. That's at
6 the bottom of the page. The Bookspan NSA docket.

7 You say, "Included in the general
8 observations regarding the letter flat differential,
9 in his direct testimony Witness Mitchell refers to
10 testimony in MC2005-3," That's the Bookspan docket,
11 correct?

12 A Yes.

13 Q Okay. "Sponsored by Witness Michelle K.
14 Yorgey." And then at the top of page 17, it says,
15 "Witness Mitchell states that the USPS testimony shows
16 no contribution from flats and considerable financial
17 gain from flats converting to letters." Correct?

18 A Yes.

19 Q Okay. Now, this reference you have to page
20 117 of Witness Mitchell's testimony is both there and
21 it's on line 18 of that page of your testimony. Page
22 117?

23 A Yes.

24 Q Okay. Other than on page 117, do you see in
25 Witness Mitchell's testimony any reference to

1 Bookspan, to Witness Yorgey, to the docket, to
2 conclusions from that docket, anything? Is that the
3 only place it appears, to your knowledge?

4 A Well, certainly page 117 is what I've
5 referenced. I don't recall without going back to
6 Witness Mitchell whether it's in other places or not.

7 Q Okay. Well, if you accept subject to check,
8 it's the only place that I could find it. And that's
9 what you're criticizing here, apparently. Let's take
10 a look at what you're criticizing.

11 First of all, in Witness Mitchell's
12 testimony about the contribution of letters and flats,
13 he makes a passing reference to the Bookspan docket
14 and this testimony of Yorgey and he says, "A situation
15 allowing this kind of arrangement where there's a lot
16 more contribution from letters and very little from
17 flats should not exist."

18 Would you concede that this is a passing
19 reference to the Bookspan docket, it isn't the core of
20 his testimony, it is simply an illustration that he
21 uses to demonstrate a weakness in the system?

22 A Well, the testimony is almost 200 pages
23 long. I would say that one individual page is
24 certainly not the core of it, but it is one of the
25 points that he raises to support the issue that flats

1 should pay more than letters.

2 Q Yes, I would say it is an example that he
3 uses and let's explore that example. Are you familiar
4 with Witness Yorgey's testimony in Docket MC2005-3?

5 A Generally, yes.

6 Q Okay. In your testimony, beginning on page
7 9, you say, "However, Witness Mitchell fails to
8 acknowledge that the revenue and cost study addressed
9 in MC2005-3 is specific to the mail of the company
10 addressed in that proceeding, Bookspan." Correct?

11 A This is lines 8 to 11 on page 17?

12 Q Exactly.

13 A Yes.

14 Q Okay. Now, I want to ask you your
15 understanding of Witness Yorgey's testimony. Is it
16 your understanding of Witness Yorgey's testimony that
17 she used costs that were specific to Bookspan's mail?

18 A No, she didn't.

19 Q Okay. What does it mean to say that
20 "Witness Mitchell fails to acknowledge that the
21 revenue and cost study addressed in MC2005-3 is
22 specific to the mail of the company addressed in that
23 proceeding, Bookspan"? Is your point that they
24 weighted the average to reflect Bookspan's volumes in
25 different rate cells?

1 A Witness Yorgey used system unit costs and
2 weighted them on Bookspan volumes in order to get a
3 weighted Bookspan cost.

4 Q Right. Never used Bookspan specific costs,
5 we've never used mailer specific costs for an NSA,
6 correct?

7 A I don't know.

8 Q Okay. But it was only the weighting process
9 that was specific to Bookspan, correct?

10 A Yes.

11 Q Okay. Let's talk about those costs just for
12 a moment. Have you had occasion to look at those?
13 Do you agree or disagree that she shows certain
14 standard flat products that have negative
15 contribution?

16 A You're talking about the standard class?

17 Q Various standard flats. Bookspan mailed
18 both standard ECR and standard regular.

19 A That's correct.

20 Q And for some of the cells which I believe
21 were in standard regular, there was negative
22 contribution. Are you aware of that?

23 A I believe that there was negative
24 contribution in some standard regular mail. I don't
25 believe there was for ECR.

1 Q Exactly. Okay. So I guess I was -- when
2 I read your statement, I thought you meant something
3 quite different because when you talked about the cost
4 study being specific to the mail the company entered,
5 I was thinking you were basing your assumption on the
6 fact that this was mailer specific cost, but since
7 we've established that it isn't, I guess I can go on.

8 In page 18 of your testimony, you have a
9 section beginning at the bottom, "Improper Rate
10 Differential for Pound Rated Mail" and that goes on to
11 19 and 20. It has to do with, in part, heavy weight
12 letters. Correct?

13 A Well, it has to do with the per pound
14 portion of the rate for pound rated mail, for letter
15 mail.

16 Q Which applies to heavy weight letters, the
17 letters that are over 3.3 ounces and less than 3.5
18 ounces?

19 A That's correct.

20 Q Okay. Do you find anywhere in Witness
21 Mitchell's testimony a proposal to change the existing
22 arrangement for heavy weight letters in ECR?

23 A I don't recall.

24 Q Let me ask you to look at section E of your
25 testimony which begins on page 22. You're dealing

1 with anomalies here, you call it "Anomalies in Witness
2 Mitchell's Non-Profit Pound Rate."

3 What is the anomaly that you see?

4 A The anomaly is that he has a negative rate
5 for pound rate. That's different than has ever been
6 proposed.

7 Q Ever been proposed for standard mail?

8 A At least for standard mail.

9 Q **And** different than the commission's ever
10 recommended for standard mail, I take it?

11 A That I can recall. Yes.

12 Q Let me clarify what we're talking about is
13 the piece component to accompany the pound rate, it's
14 for pieces that pay both the piece rate and the pound
15 rate, correct? It's not the minimum piece rate we're
16 talking about, we're talking about the piece part Of a
17 piece pound rate, correct?

18 A That's correct.

19 Q **And** you call a negative piece rate an
20 anomaly. Correct?

21 A Yes.

22 Q And you would advise against that and think
23 that would be an improper way to set rates, I take it?

24 A Yes.

25 Q I'd like to hand you a copy of a postage

1 statement, Form 3602N. Are you familiar with 3602s?

2 A No, I'm not.

3 Q Okay. There are a variety of 3602s. One of
4 them is for non-profit standard mail and it's a
5 3602N1, revised January 2006 and the form is,
6 I believe, seven pages long and the last page is
7 instructions. Does that look about right to you in
8 terms of my description?

9 A That's correct.

10 Q Okay. Please take a look at page 5 of this
11 form. In the middle, Part J, do you see that? And
12 I want you to look at -- it's under the heading "Heavy
13 Letters," the whole section, and I want you to look at
14 the column about an inch and a quarter from the left
15 margin that says "Piece Rate." Do you see that
16 column?

17 A Yes, I do.

18 Q And if you could look down that column and
19 tell me if you see any negative piece rates?

20 A There is one.

21 Q Just one?

22 A Yes, .006.

23 Q So in point of fact, there's one for no
24 destination entry, one for DBMC entry and one for DCSF
25 entry, is there not? Do you see three negative

1 numbers?

2 A Yes, I do.

3 Q Okay. Is this a surprise to you when you
4 see these negative numbers in the current form?

5 A Yes, it is because when I looked at the
6 domestic mail manual and the rates, I didn't see a
7 negative number.

8 Q Do you have any evidence that you know of
9 that non-profit mailers are confused by this? This
10 is, first of all, a pretty long form to begin with,
11 correct?

12 A It's seven pages.

13 Q Do you have any specific information to
14 share about how the Postal Service or its computers
15 might be having problems with these negative numbers?

16 A No, I don't.

17 Q Now that you know that this is already
18 begin done, the negative component of the piece pound
19 rate for non-profit mail in some instances, would you
20 agree with me that it's not quite fair to describe
21 Witness Mitchell's proposal as an anomaly, but rather
22 consistent with current practice?

23 A Well, no. I'm not quite sure how this
24 negative number is applied currently, but, as I said,
25 I don't recall looking at the domestic mail manual and

1 the listing of the rates and seeing the negative
2 number.

3 Q But you do see it today.

4 A Yes, I do.

5 Q Okay. **And** what I'm suggesting is that in
6 your testimony you said it was anomalous and should
7 not be recommended and I'm asking you if now knowing
8 what you now know which you didn't know before you
9 might want to modify the adjective anomalous.

10 A Well, I mean, there are probably 400 to 500
11 numbers on this form and three of them are negative.
12 The .06 is anomaly on this page is also.

13 Q A moment ago you said it had never occurred
14 in standard mail to your knowledge.

15 A That was a true statement.

16 Q And apparently it has and I'm just saying if
17 something is repeated in various rate cases, it's not
18 an anomaly, is it, for Witness Mitchell to continue
19 forward the current practice?

20 A Well, it's not as large an anomaly as
21 perhaps I thought it was before.

22 Q But you want to stick with anomaly?

23 A Yes.

24 MR. OLSON: Thank you, Mr. Prescott.

25 Thank you, Mr. Chairman.

1 CHAIRMAN OMAS: Thank you, Mr. Olson.

2 Is there anyone else who wishes to
3 cross-examine Witness Prescott?

4 (No response.)

5 CHAIRMAN OMAS: Are there any questions from
6 the bench?

7 (No response.)

8 CHAIRMAN OMAS: There are none.

9 Mr. Todd, would you like some time with your
10 witness?

11 MR. TODD: Yes, but I think I need only the
12 briefest amount of time, if I could just confer?

13 CHAIRMAN OMAS: We will sit and wait.

14 (Pause)

15 MR. TODD: Mr. Chairman, we will have no
16 redirect.

17 CHAIRMAN OMAS: Thank you, sir.

18 Thank you, Mr. Prescott, for your appearance
19 here today. We appreciate your testimony and **your**
20 contribution to the record and you are now excused

21 (The witness was excused.)

22 CHAIRMAN OMAS: This concludes today's
23 hearing. We will reconvene tomorrow morning at **9:30**,
24 when we will receive testimony from Witnesses Miller,
25 Kiefer, Culic, Siwek, Mitchum and Bellamy.

1 Thank you very much and have a nice evening.

2 (Whereupon, at 4:10 p.m., the hearing was

3 adjourned, to be reconvened the following day,

4 Thursday, November 30, 2006, at 9:30 a.m.)

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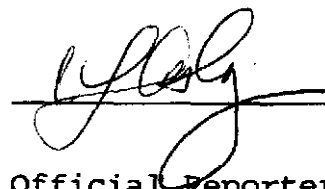
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DOCKET NO. : R2006-1
CASE TITLE: Postal Rate and Fee Changes
HEARING DATE: 11/29/06
LOCATION: Washington, D.C.

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the Postal Rate Commission.

Date: 11/29/06



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